

By June Summers Haas and Patrick R. Van Tiflin

Service Transactions Versus Sales of Goods: A New Standard



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Distinguishing between the sale of a service and the sale of goods is a tax policy issue courts across the country have grappled with recently. For Michigan sales and use tax purposes, if a sale of personal property is involved, the transaction may be subject to a state sales or use tax. If, on the other hand, the transaction involves the performance of a service—unless that service has been specifically subjected to sales or use tax by the individual state—the transaction is free of sales or use tax.

The Michigan Supreme Court recently clarified the method for determining whether a transaction is primarily the sale of a service or the sale of a tangible good. In *Catalina Marketing Corporation v Michigan Dept. of Treasury*, the Michigan Supreme Court on May 5, 2004, adopted for Michigan the “Incidental to Service” test. The Court overruled lower court decisions of the Michigan Tax Tribunal and the Court of Appeals which had employed the “Real Object” test.

A closer look at the *Catalina* case

To better understand the Supreme Court's decision in *Catalina*, some explanation of the nature of Catalina's business is necessary. Catalina's clients are consumer product manufacturers. Catalina provides its clients with “alternative mass marketing strategies” through its Checkout Coupon™ Program. The Checkout Coupon™ Program utilizes the universal product codes, or bar codes, that appear on the packaging of most consumer goods. Catalina has developed hardware and software to collect data on the products as they are scanned

at the checkout register. Using this data, Catalina contracts with its manufacturer-clients to develop a marketing program to target certain specified shoppers as they check out at a grocery store or other retail establishment and to deliver a coupon or advertising message on the basis of what they buy.

The Catalina Performance Agreement calls for the payment by the manufacturer to Catalina of the greater of a base fee or a fee for each coupon or advertising message. The base fee and coupon fee varies, based upon the product category involved and whether the triggering event is a purchase of the manufacturer's product (\$.035), the purchase of a competitor's product (\$.06), or the purchase of a product which is complimentary to that produced by the manufacturer-client (\$.05). The difference in the price charged by Catalina relates to the relative degree of difficulty in data analysis and the level of sophistication of the analysis that the Catalina software must perform in order to determine whether, and how, to appropriately respond to the triggering event identified by the manufacturer-client. Significantly, however, the manufacturer-client pays Catalina the base fee for the four-week cycle without regard to whether any coupons or advertising messages are issued at all. This compensates Catalina for granting the manufacturer access to its customized proprietary software and the manufacturer's exclusive use of that software for a specific product category during the four-week market cycle.

How the *Catalina* case evolved

The Michigan Department of Treasury took the position that Catalina was a coupon printer and assessed Michigan use tax to Catalina based upon the fees it received from its manufacturer-clients. The Michigan Tax Tribunal affirmed the assessment by employing the Real Object test set forth by the Michigan Department of Treasury in its Revenue Administrative Bulletin 1995-1. Under this RAB, the Tribunal looked at whether, solely from the perspective of the manufacturer-client, the real object was the purchase of a tangible good or the receipt of services. The Court of

Appeals affirmed using the Real Object test. Both the Tribunal and the Court of Appeals ignored the Michigan Court of Appeals decision in *University of Michigan Board of Regents v Michigan Dept. of Treasury*, 217 Mich App 665; 553 NW2d 349 (1996) in which the Court had employed the Incidental to Service test.

The Supreme Court criticized the Tribunal and the Michigan Court of Appeals for accepting Treasury's administratively created Real Object test. To a certain extent, the Supreme Court was defending the concept of separation of powers under the Michigan Constitution and it saw the adoption of the Real Object test by the Department as an infringement on the province of the Legislature to legislate and the disregard for a prior Court of Appeals decision as lack of deference to the judiciary. Addressing itself to the substance of the issue, the Court stated:

The weakness of this [real object] test is that it is not consistent with the statutory definition of "sale and 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.

Thus, the Court held that sales tax will not apply to a transaction where, looking objectively at the entire transaction, the transaction is principally the provision of a service, even though tangible personal property is exchanged incidentally.

Court issues guidelines

The Supreme Court set forth the following factors to be applied by a court when determining whether the transfer of tangible personal property is incidental to the provision of services: 1) What the buyer sought as the object of the transaction; 2) What the seller or service provider is in the business of doing; 3) Whether the goods were provided as a retail enterprise with a profit-making motive; 4) Whether the tangible goods were available for sale without the service; 5) The extent to which intangible services have contributed to the value of the physical item that is transferred; and 6) Any other factors relevant to the particular transaction.

Ramifications of court decision broad

The decision of the Michigan Supreme Court in *Catalina* has broad ramifications across industries. Businesses involved in all manner of personal services are potentially affected and should reexamine the character of their business transactions under the Incidental to Service test.

This case also represents the second time in two years that the Supreme Court has rejected a position taken by Treasury in a Revenue Administrative Bulletin. These Bulletins are not adopted in accordance with the Administrative Procedures Act and, therefore, do not have the force of law.

Businesses faced with an Administrative Bulletin which adversely affects the interest of the taxpayer should not be deterred by the existence of the Bulletin, but should instead analyze whether the Bulletin properly carries out the intent of the underlying statute being administered by Treasury.

What remains to be done

In an extraordinary procedural move, the Supreme Court retained jurisdiction; ordered the Tax Tribunal to issue a new decision by August 3, 2004, ordered *Catalina* and the Department of Treasury to each submit a brief with the Michigan Supreme Court 35 days after the new decision by the Tribunal, and granted *Catalina* and Treasury the opportunity to request re-argument.

The retention of jurisdiction by the Supreme Court seems to communicate the keen interest which the Supreme Court has in the proper implementation of the Incidental to Service test in Michigan. It was apparent from the questioning of Counsel by the Justices during oral argument in the *Catalina* case that the Court is very concerned about the impact its decision will have on the development of the new economy, which involves the increasing prevalence of the sale of services versus the sale of goods.

The forthcoming decisions by the Michigan Tax Tribunal and Michigan Supreme Court should be followed closely by all taxpayers who participate in the electronic age. **MF**

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