Rulings of the Tax Commissioner

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Tax Type: Retail Sales and Use Tax
Brief Description: Research and Development, Online games
Topics: Appropriateness of Audit Methodology; Exemptions
Date Issued: 01/18/2003

January 18, 2003

Re: § 58.1-1821 Application: Retail Sales and Use Tax

Dear *****:

This is in response to your letter submitted on behalf of ***** (the "Taxpayer") to request correction of the retail sales and use tax assessment issued to the Taxpayer as a result of an audit. I apologize for the delay in responding to your letter.

FACTS

During the audit period, the Taxpayer developed and published multi-player online games and distributed game content platforms to Internet service providers and online services. An audit for the period July 1994 through April 2000 resulted in the assessment of tax on computer hardware and software, supporting equipment and accessories, and maintenance contracts.

The Taxpayer contests the entire audit assessment on the grounds that the assessed tangible personal property qualifies for the research and development exemption pursuant to *Va. Code* § 58.1-609.3(5). In this regard, you maintain that if any taxable use was made of the research property, such taxable use was *de minimis.* In addition, the Taxpayer maintains that most of the contested items are exempt of the tax pursuant to the audiovisual exemption set out in *Va. Code* § 58.1-609.6(6).

DETERMINATION

Research and development

Va. Code § 58.1-609.3(5) provides an exemption from the retail sales and use tax for:

> Tangible personal property purchased for use or consumption directly and exclusively in basic research or research and development in the experimental or laboratory sense. (Emphasis added.)

The mandate for exclusive use notwithstanding, Title 23 of the Virginia Administrative Code (VAC) 10-210-3071(C) indicates that if research property is used in some taxable manner, that research property "will continue to be exempt from the tax if the taxable

use is *de minimis* in nature." The regulation also indicates that taxable use of research property is considered to be *de minimis* if the taxable use:

1. Does not involve a continuous or ongoing operation,
2. Does not follow a consistent pattern, *i.e.,* weekly, monthly, quarterly, etc.,
3. Is occasional in nature occurring no more than three times, and
4. In total, accounts for no more than three days.

The *de minimis* usage applies only if the property meets all four criteria cited above. Furthermore, pursuant to *Va. Code* § 58.1-205, the burden of proof is upon the Taxpayer to establish that the above *de minimis* criteria are not exceeded in order for the research and development exemption to apply to the contested items.

You claim that any taxable use of the contested computers was *de minimis* in nature. In this regard, you maintain the Taxpayer's computer hardware (that to some extent may have been equipped with e-mail and Internet access capability) was so equipped not to facilitate administrative functions, but to enable developers to carry out their day-to-day research and development activities. You further maintain that it is likely some of the computers in question were never equipped for internal e-mail or Internet access.

I understand, however, that the Taxpayer books its operating expenditures into a number of basic areas, including (1) the holding company, (2) the retail subscription portal (whereby customers can subscribe to and play the Taxpayer's online games), and (3) the aggregating, publishing and distribution domain (which includes publication of its own and other developers' games). These activities include administrative functions, retail subscription services, and assisting third-party publishers. It appears very unlikely that assets used in these three activities would satisfy the direct use mandate of the exemption.

The fourth basic area involves software development, and the audit staff agrees that this activity would likely include exempt research and development. This is consistent with 23 VAC 10-210-765(A). This regulation indicates that the research and development exemption applies to "computer hardware and software used in programming and other developmental activities with respect to new computer software products ...."

To determine direct and exclusive use of tangible personal property with respect to this software development activity, the audit staff requested a tour of the Taxpayer's facility. Such a tour would have allowed the audit staff to determine the use of the contested equipment, including e-mail applications, (such as inbox, deleted items, specialized folders, etc.), and Internet access software (reviewing bookmarks, cookies, downloads, and other traceable uses showing content, frequency, and duration of taxable usage). However, the Taxpayer denied the audit staff's request to tour its facility to verify the Taxpayer's claims of direct and exclusive use.

You indicate that a physical examination of the contested property would be impossible

because the Taxpayer replaces its computers every year or two. Consequently, many of the assessed items, especially from the early part of the audit period, were no longer in use. I certainly do not disagree with your observation. Still, an on site tour would have at least provided a greater understanding of how contested items were used.

Now, and as a result of the Taxpayer's reorganization, there appears to be no practical way to verify any of the Taxpayer's claims that the research and development exemption applies to the contested items. I understand that the Taxpayer's software development department was eliminated after the conclusion of the audit and several months prior to the submission of your appeal in this matter. The means to verify the Taxpayer's claim of direct and exclusive use is no longer available.

Based on the foregoing, the Taxpayer has not met its burden of proof as required under the law that the contested items qualify for the research and development exemption.

Audiovisual works

Effective July 1, 1995, *Va. Code* § 58.1-609.6(6) provides an exemption from the retail sales and use tax for:

> a. (i) The lease, rental, license, sale, other transfer, or use of any audio or video tape, film or other audiovisual work where the transferee or user acquires or has acquired the work for the purpose of licensing, distributing, broadcasting, commercially exhibiting or reproducing the work or using or incorporating the work into another such work; (ii) the provision of production services or fabrication in connection with the production of any portion of such audiovisual work, including, but not limited to, scriptwriting, photography, sound, musical composition, special effects, animation, adaptation, dubbing, mixing, editing, cutting and provision of production facilities or equipment; or (iii) the transfer or use of tangible personal property, including, but not limited to, scripts, musical scores, storyboards, artwork, film, tapes and other media, incident to the performance of such services or fabrication; however,
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> > audiovisual works and incidental tangible personal property described in clauses (i) and (iii) of this subsection shall be subject to tax as otherwise provided in this chapter to the extent of the value of their tangible components prior to their use in the production of any audiovisual work and prior to their enhancement by any production service; and
>
> b. Equipment and parts and accessories thereto used or to be used in the production of such audiovisual works. [Emphasis added.]

You contend the Taxpayer's Internet-based games constitute "other audiovisual works" for purposes of this exemption because (1) the "statute makes no reference to any requirement that the audiovisual work must be 'tangible' in nature," and (2) the term

"audiovisual work" is "open to interpretation" and, therefore, intended to be interpreted in a variety of ways. In this regard, you claim that the term "audiovisual works" used in the statute includes those audiovisual works transferred electronically via the Internet. For these reasons, you maintain that subdivision b of the exemption applies to computer hardware and software, supplies, and other equipment used by the Taxpayer to develop and produce its online games.

To support your claim, you indicate that the Taxpayer's Internet-based games include artwork, sound, simulation, and role-playing. You further point out that the games are "substantially the same as computer or video games purchased through retail establishments" and are commercially available and playable over the Internet. In effect, you conclude that the Taxpayer's product is an audiovisual work because it has audiovisual content and is commercially available.

I am concerned that this same conclusion can be applied to every computer-related game. Doing so violates the clear intent of the statute, *i.e.*, to encourage film production in Virginia. This intent is plainly stated in the Department's impact statement developed for House Bill 1580 (copy enclosed) of the 1995 Session of the General Assembly. In like fashion, it is the Department's long-standing policy to apply the exemption to feature film, program and documentary producers, audiovisual production companies, and others engaged in the production of tapes for licensure, distribution, commercial exhibition, broadcast, or for use in the production of another exempt work. See Public Document (P.D.) 95-198 (7/31/95), P.D. 96-12 (3/7/96) and Tax Bulletin 95-5 (6/23/95).

Further, the audiovisual works exemption exempts certain tangible personal property from the sales and use tax. Claiming that an Internet-based game is an "other audiovisual work" ignores the basic principle of the Virginia Sales and Use Tax Act that it is the tangible nature of property that subjects it to the sales and use tax. This same issue was addressed by the Department with respect to 2001 Senate Bill 1292 (copy enclosed) that addressed the application of the audiovisual exemption to online products.

Under the legal doctrine *"noscitur a sociis"* which translates to "it is known from its associates," the meaning of a word "takes color and expression from the purport of the entire phrase of which it is a part, and it must be read in harmony with its context." Turner v. Commonwealth, 226 Va. 456, 309 S.E.2d 337 (1983). Under another fundamental rule of construction, the rule of *"ejusdem generis"* provides that "where general words follow an enumeration of persons or things by words of a particular and specific meaning, the general words are not be construed in their widest extent, but are to be held as applying only to persons or things of the same general kind or class as those specifically mentioned. In other words, general words in such a situation are to be restricted to a sense analogous to the less general." East Coast Freight Lines v. City of Richmond, 194 Va. 517, 1953.

Therefore, the term "other audiovisual work" must be read in harmony with the rest of

the phrase, which refers to audio or video tapes and films. Thus, "other audiovisual work" refers to those audiovisual works that are similar to taped radio program works or feature films, TV movies and programs, and similar cinematographic works. Based on the foregoing rules and policies and the doctrine of strict construction adopted by the courts in interpreting exemptions from the tax, I must conclude that the audiovisual exemption does not extend to the Taxpayer's audiovisual games.

Conclusion

Based on this determination, the assessment is correct. A consolidated bill, with interest accrued to date, will be mailed shortly to the Taxpayer. No additional interest will accrue provided the outstanding assessment is paid within 45 days from the date of this letter.

The *Code of Virginia,* regulations and public documents cited are available online in the Tax Policy Library section of the Department of Taxation's web site, located at www.tax.state.va.us. If you have any questions about this determination, you may Contact ***** in the Department's Office of Policy and Administration, Appeals and Rulings, at *****.

Sincerely,

Kenneth W. Thorson
Tax Commissioner

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