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The “True Object” Test v. Technology

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Given the growth of the service industry, the “true object” (or “essence of the transaction”) test continues to play an important role in determining the taxability of “mixed transactions”—transactions involving both taxable and nontaxable business activities that are not separable. Most commonly, mixed transactions involve the taxable sale of tangible personal property and the nontaxable provision of services. Under the test, if the true object of the transaction is the transfer of tangible personal property, the entire transaction is taxable. If the true object of the transaction is the provision of nontaxable services, the entire transaction is not taxable.

While the test may sound simple, its application is often anything but. Courts have long struggled with the inconsistent application of the test and have developed their own factors in applying it. In the Missouri Supreme Court’s recent decision in *Western Blue Print Co. v. Director of Revenue*,¹ the taxpayer prevailed under the court’s “true object” analysis. While the Missouri Supreme Court reached the correct decision, the factors applied by the court may become less relevant in the future as technology advances.

Bright-line rules about the true object of a transaction that once seemed clear are now questionable given the expansion of YouTube, iTunes, the Kindle, and the iPad. Until the legislation catches up with technology, the courts may need to reexamine their reliance on outdated tests.

Western Blue Print Co. v. Director of Revenue

In *Western Blue Print Co.*, the Missouri Supreme Court applied the “true object” test to the “electronic scanning of paper documents onto CDs.”² *Western Blue Print Co.*’s customers provided the company with documents they wanted to view in an electronic format. *Western Blue Print* scanned images of the documents onto CDs and returned the documents and CDs to its customer. The main issue was whether the real object sought by the buyer was the CD or the intangible information on the CD. To resolve the issue, the court looked at Missouri Supreme Court precedent.

¹ No. SC 90172 (Mo. 2010).

² No. SC 90172 (Mo. 2010).

Missouri Supreme Court Precedent

*James v. TRES Computer Systems, Inc.*³ involved the sale of custom-made computer software on magnetic tapes. The court held that the company’s sales were not taxable, other than the \$50 value of the tapes already remitted, because the intangible data on the tapes, not the tapes themselves, was the ultimate object of the sale. The court reasoned that the tapes were not important to the transaction because: (1) the tapes could be thrown away after the buyers downloaded the information; and (2) the information could have been sent electronically or on any other tangible form instead of on tape. The tapes themselves were “mere conduits or containers” for the real object of the transaction, the intangible data.

In *K&A Litho Process, Inc. v. Director of Revenue*,⁴ the company received film transparencies that it used to create a color key by separating the colors in the transparency onto a sheet of film. The company then sold the color key and the film to printers who used the objects to create plates for printing photographs. After creating the plate, the printers threw away the color key and film. The court held that the sale of the color key and film to the printers was not taxable because the true object of the sale was not the tangible personal property but the company’s skill in producing the objects. The court reasoned that the tangible items were just the media of transfer for the transparency colors and, once used, were of no further value. The tangible items were merely a “segment of a larger production operation” that did not render the transactions taxable sales.

*Gammaitoni v. Director of Revenue*⁵ involved the sale of original and duplicated videotapes containing instructional seminars, depositions, and accident reconstructions. The court held that the sales were taxable because the ultimate object of the transaction was the finished videotapes and not the services rendered in making the videotapes. The court reasoned that the buyers already had the information they needed to make the tapes; they just wanted the company to put the information on tape so that others could view it.

In *Universal Images v. Department of Revenue*,⁶ the company produced custom advertisements for businesses that were played in movie theaters. The advertisements were produced on films that were then played repeatedly at one or more theaters over a period of time. The court held that the transaction was subject to use tax because the finished film—tangible personal property—was the true object of the sale and was being stored or used in the state.

Application to *Western Blue Print Co.*

The Missouri Supreme Court reasoned that Western Blue Print Co.’s CDs, like the tapes in *TRES*, were mere conduits of data that could be discarded after the data was downloaded to a customer’s computer. The court noted that the transactions fell into a category of transactions in which “tangible personal property ‘serves only as the medium of transmission for an intangible

³ 642 S.W.2d 347 (Mo. 1982).

⁴ 653 S.W.2d 195 (Mo. 1983).

⁵ 786 S.W.2d 126 (Mo. 1990).

⁶ 608 S.W.2d 417 (Mo. 1980).

product or service’ ” and thus were not taxable. Additionally, the Missouri Supreme Court held that like the color key and film in *K&A Litho Process*, the CDs were only a “segment of a larger production operation.”

The court distinguished Western Blue Print Co.’s operations from the facts in *Gammaitoni* and *Universal Images*. Unlike *Gammaitoni*, where the service of manufacturing the tapes was incidental to the sale of the videotapes, Western Blue Print Co.’s CDs were incidental to the intangible data on the CDs. Unlike *Universal Images*, where the customers bought a finished product, the customers in *Western Blue Print* bought the conversion of their data into electronic format as a medium of transmission, not a finished product—the customers will presumably discard Western Blue Print Co.’s CDs once the information is transferred to their computers.

Comment

The Missouri Supreme Court considers several factors when analyzing a transaction under the “true object” test: (1) whether the buyer wants the intangible data/service/skill or the finished product; (2) whether the medium of transfer is of further use to or retained by the buyer after downloading/playing; and (3) whether the information could have been sent by means other than tangible personal property.

From the above cases, it appears that a distinction exists between information that can be sent electronically and information that is not sent electronically (or rather was not sent electronically when those cases were decided), such as movies, records, and books.

This distinction may be outdated in today’s world where many forms of media are bought and sent electronically. In 1982, *TRES* emphasized that tapes containing computer software differed from movie films, records, and books in that the data on the tapes could be stored on any form, whereas films, records, and books were the only practicable ways of preserving those types of media. Further, according to *TRES*, “while those articles and the tapes are similar in that they physically represent the transfer of ideas or artistic processes, a more significant distinction is that those articles are inseparable from the ideas or processes, whereas computer programs are separable from the tapes.” In 1982, however, the personal computer was in its infancy and the iPad was not yet the apple of its creators’ eye.

Given that today movies, CDs, and books are sent, read, and listened to electronically with the help of YouTube, iTunes, the Kindle, and the iPad (to name but a few), it may be harder to argue that the medium is really inseparable from the ideas. While the “true object” test continues to play an important role in determining the taxability of mixed services, until the legislation catches up with technology, the courts may need to reexamine the factors they use to apply the test.



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