

MORGAN, THEELER, WHEELER,
COGLEY & PETERSEN, L.L.P.,
Appellant,
v.
SOUTH DAKOTA
DEPARTMENT OF REVENUE AND REGULATIONS,
Respondent.
[2005 SDCC 1]

In Circuit Court
Sixth Judicial Circuit
Appeal from Dept of Revenue and Regulations
HU04-235—Reversed

Donald W. Hageman, Dept of Revenue, Pierre, SD
Attorney for Respondent.

Jack Theeler, Mitchell, SD
Attorney for Appellant.

Opinion Filed Mar 1, 2005

Max A. Gors, Circuit Court Judge.

[¶1] Morgan, Theeler, Wheeler, Cogley & Peterson, L.L.P. (the Law Firm) contested an assessment of tax by the Department of Revenue and Regulation (the Department). The Department audited the Law Firm and issued a certificate of assessment. The Law Firm contested \$2,575.20 of the assessment. An administrative Hearing Examiner Hillary Brady recommended that the assessment be affirmed. The Secretary of Revenue adopted Brady's proposed decision and affirmed the certificate of assessment. The Law Firm appealed. Reversed.

Facts

[¶2] The Law Firm practiced in Mitchell and Huron, South Dakota. The Law Firm required clients to reimburse charges for long distance telephone calls, faxes and copies incurred on the clients' behalf. Charges were itemized on the clients' statements separately from the fees for legal services. Sales tax was not charged on itemized reimbursable costs. The Department determined that the expenses which the Law Firm charged to clients for reimbursement were taxable.

[¶3] Several years ago, the Law Firm concluded that it spent a lot of time and money to itemize phone calls and faxes made on behalf of clients. Therefore, the Law Firm added all of its long distance phone calls for a year and established an average charge of \$2.00 for each long distance phone call made on behalf of a client. The Law Firm averaged fax and photocopy charges the same way and established a flat fee of \$2.50 for faxes and 25¢ per photocopy. When a long

distance phone call, fax or photocopy was made on behalf of a client, it was added to the client's account. Each long distance phone call, fax and photocopy was listed on the client's bill as a reimbursable expense. The Law Firm did not charge sales tax on the reimbursable expenses.

[¶4] The Department audited the Law Firm for the time period from September, 1998, through August, 2002. The Department assessed deficiencies totaling \$4,884.77. The Law Firm paid the full amount but contested the assessment made by the Department regarding reimbursable expenses. The Department concluded that the Law Firm's long distance phone calls, faxes and photocopies were not reimbursable expenses exempted from sales tax because the Law Firm charged a flat fee and not the exact cost of each telephone call, fax or photocopy. The Department assessed sales tax of \$2,575.20 on those items.

Standard of Review

[¶5] SDCL 1-26-36 contains the standard of review for an administrative appeal. *Brown v. Douglas School District*, 2002 SD 92, ¶9, 650 NW2d 264, 267. Questions of fact are viewed under the clearly erroneous standard while questions of law are review de novo. *Id.* Great weight is given to the agency's findings of fact and inferences drawn. *Sopko v. C & R Transfer Company, Inc.*, 1998 SD 8, ¶6, 575 NW2d 225, 228. This court will only reverse factual issues if it is firmly and definitely convinced a mistake was made. *Id.* The appropriate standard of review of an administrative determination is not whether there is substantial evidence contrary to the agency's findings but rather if there is substantial evidence to support the agency's findings. *State Department of Social Services vs. Rodvik*, 264 NW2d 898 (SD 1978). Questions mixed with fact and law are fully reviewed. *Herr v. Dakotah, Inc*, 2000 SD 90, ¶11, 613 NW2d 549, 552. Matters dealing with statutory construction are reviewed de novo. *Doe v. Quiring*, 2004 SD 101, ¶8, 686 NW2d 918, 920.

Analysis and Decision

[¶6] SDCL ch. 10-45 imposes a tax on gross receipts from the sale of services. Legal services are specifically subject to the tax. However, SDCL 10-45-29.1 allows attorneys to deduct from gross receipts certain expenses incurred on behalf of and reimbursed by clients. SDCL 10-45-29.1 contains the following:

In determining the amount of tax due under this chapter, attorneys licensed pursuant to chapter 16-16 and accountants licensed pursuant to chapter 36-20A may deduct from gross receipts amounts which represent charges to clients for tangible personal property or services purchased by the attorney or accountant on behalf of a client. However, the sale of the property or service to the attorney or accountant is not a sale for resale if this deduction is taken. *This deduction may only be taken if the amount to be deducted represents an expense specifically incurred for a particular client and the amount is itemized and separately billed as a reimbursable expense by the attorney or accountant.* (Emphasis added.)

The statute exempts expenses 1) which are specifically incurred for a particular client and 2) which are itemized and separately billed as a reimbursable expense. The Law Firm met the two requirements of the statute. First, each expense itemized on a client's bill was specifically incurred for that particular client. If the Law Firm made a call for Jane Doe, the attorney marked Jane

Doe's time slip with one phone call. Second, the charge was itemized and separately billed as a reimbursable expense. When the Law Firm billed Jane Doe, the charge for legal fees and sales tax was in one section and the reimbursable expenses were itemized in a separate section. Jane Doe's bill reflected one phone call for \$2.00 under reimbursable expenses. No sales tax was added to the \$2.00 for the phone call.

[¶7] The Law Firm bought long distance service by the minute from a telephone provider. The Law Firm paid sales tax on its phone bill, including long distance service. The Law Firm billed each client a flat fee per call to reimburse the Law Firm for the phone calls made on the client's behalf. If no phone calls were made on behalf of a client, the client was not charged for any of those items. The flat fee per call that the Law Firm charged did not cover or exceed the expenses for phone calls nor did the Law Firm make a profit from the charges.

[¶8] Each fax by the Law Firm sent on behalf of a client was marked on a time slip for the client. The fax 1) was specifically incurred for a particular client and 2) the amount was itemized and separately billed as a reimbursable expense by the attorney as required by SDCL 10-45-29.1.

[¶9] The photocopies made by the Law Firm were also billed as a reimbursable expense. When a photocopy was made for a client, the copy was marked on a time slip for the client and included as a reimbursable expense on the client's bill. The copy 1) was specifically incurred for a particular client and 2) the amount was itemized and separately billed as a reimbursable expense by the attorney as required by SDCL 10-45-29.1. The Department determined that only copies made by a third party were reimbursable expenses. However, the statute does not require that the copies be made or the money be paid to an outside source. The Law Firm bought the paper, the toner and the copy machine to make the copies. The Law Firm paid sales tax on purchases from all those suppliers. The 250 which the Law Firm charged for copies did not include staff time spend in making copies; 25¢ only reimbursed the Law Firm for the supplies and equipment used to make the copies. The Law Firm did not recover all of its copying costs and did not make a profit on the copies.

[¶10] The Department insisted that the amount charged to each client was not the *exact* cost of the exact phone call, fax or copy. The Department argued that in order for it to be deductible under SDCL 10-45-29.1, the cost must be the exact cost. The statute does not require the Law Firm to seek reimbursement from its clients for the exact amount incurred. The pertinent part of the statute reads "*represents an expense specifically incurred for a particular client*". The Department interpreted the statute with the word "specific" in front of the word "expense" rather than after the word where it actually appears in the statute. Instead, specifically modifies the phrase "incurred for a particular client". The statute says the expense must be specifically incurred for that client. In dealing with the expense; the statute only says the amount must "represent" an expense. The flat fee charged by the Law Firm did "represent" an expense. The flat fee was an average of their phone calls, faxes and copies per year.

[¶11] The Department read the statute with different wording. The statute cannot say more than it does, but it can be interpreted in different ways. Both sides use *In the Matter of the Sales and Use Tax Refund Request of Media one, Inc.* as to how a statute should be interpreted, which contains the following:

The question of whether a statute imposes a tax under a given factual situation is

a question of law. Statutes which impose taxes are to be construed liberally in favor of the taxpayer and strictly against the taxing body. Statutes exempting property from taxation should be strictly construed in favor of the taxing power. The words in such statutes should be given a reasonable, natural, and practical meaning to effectuate the purpose of the exemption.

1997 SD 17, ¶9, 559 NW2d 875, 877. While, this Court acknowledges that a statute granting an exemption should be construed strictly in favor of the taxing power, the Court also acknowledges that the words in statutes should be given a “reasonable, natural, and practical meaning to effectuate the purpose of the exemption.” Interpreting the statute to mean exact, does not give the words reasonable, natural, or practical meaning. The average costs for calls, faxes and copies were formulated in a reasonable manner and the fees themselves were reasonable. It would be time consuming and expensive to bill the exact amount of each phone call to each client. It is not reasonable, practical or help effectuate the purpose of the statute to read the word “exact” in front of expense.

[¶12] The State of South Dakota in its infinite wisdom has embraced estimation and averaging for reimbursing small expenses incurred by state employees. Instead of requiring receipts for each meal, employees receive a flat rate^{fn1} based on the time of day the employee left and the time of day the employee returned. ARSD 5:01:02:14(2). All employees are reimbursed at the same rate for the same meal without regard to whether the employee paid more or less than the set amount. The employee can even skip a meal and still get paid. The result is a savings of employee time to gather, retain and submit receipts and a savings of auditing time to review receipts. (Also, an added benefit is that no one complains that one employee got to eat a better meal than another at State expense.)

[¶13] The State uses the same averaging to reimburse employees for personal auto mileage. Employees receive 32¢ per mile whether they drive a Puegot or a Porsche. ARSD 5:01:02:01. The driver of the gas hog loses money and the driver of the economy car makes money. However, the State goes one step further with mileage. The State even averages miles. An employee gets the “map” miles from Pierre to Rapid City, not the actual miles driven. ARSD 5:01:01:01(2). Again, the reason is ease of accounting and auditing. The employee is not required to write down beginning and ending mileage or to keep track of and deduct personal miles traveled at the destination (e.g., driving to supper or shopping at the Rushmore Mall). The auditor has only to look up the “map” miles and multiply by the mileage rate. Less records, less mistakes, uniformity, less fraud; everybody is better off.

[¶14] The Law Firm applied the same solution used by the State of South Dakota. The staff time spent looking up each phone call and fax, billing it to the client’s account and itemizing the call or fax exactly on the bill would exceed the reimbursed expense of all but the most expensive calls and faxes. Similarly, determining the exact cost of each copy made for a client would be equally costly and probably impossible. Every business that charges for copies determines the price per copy by averaging the cost of machine usage (rent or purchase), repairs, maintenance, cleaning, toner, paper and electricity. The Unified Judicial System is no exception; copies at the clerk of courts office are billed at a flat rate of 20¢ per copy. Judicial Accounting System Manual at page 71. No one presents a bill that says, “We just put in a new toner cartridge so your first copy will be \$39.95, and each one after that will be 25¢ apiece.”

[¶15] What is sauce for the goose is sauce for the gander. *Street v. Farmers' Elevator Co.* of Elkton, 33 SD 601, 629, 146 NW 1077, 1088 (1914). The State averages petty costs for reimbursable expenses and the Law Firm does too. Absent a change in the statute, if it is close enough for government work, it should be close enough for law office work too.

[¶16] The Department also argues that copies are only reimbursable expenses qualifying for the exemption if the lawyer has the copies made at Kinko's (or some other emporium of equivalent enterprise). This does not pass the straight-face test.^{fn2} First, there is no Kinko's in White River or half of the other places where lawyers practice law. The Department cannot seriously expect a Mellette County lawyer to drive to Pierre to make a copy for it to be a reimbursable expense exempt from sales tax. Second, even if Kinko's has a store in Mitchell (which may or may not be the case, but surely a bustling metropolis like Mitchell has the functional equivalent), it would cost the Law Firm, and consequently the client, more to send someone to Kinko's every time a copy is needed than to have a copier handy in the corner where everyone in the office, even the lawyers, can have virtually instant access to inexpensive copies. Sam Rayburn once said, "If a man has common sense, he has all the sense he needs." The Law Firm used common sense in averaging reimbursable expenses. The Department of Revenue would impose extensive and expensive procedures that would have the practical effect of eliminating the exemption. If the Department of Revenue wants to eliminate the exemption it should repeal it, not audit it out of existence. Government should simplify not obfuscate.

[¶17] Both parties point to SDCL 10-59-27 which contains the following:

Any taxpayer who has received written advice from the Department of Revenue and Regulation concerning the taxability of transactions shall be allowed to rely on such advice when filing tax returns. However, the taxpayer shall maintain a copy of the advice in the taxpayer's business records. The department may not maintain a position against a taxpayer which is inconsistent with a prior written opinion issued to the same taxpayer unless rescinded by the department, by a change in statutory law or reported case law, by a change in federal interpretation in cases if the department's written advice was predicated upon a federal interpretation or by a change in material facts or circumstances relating to the taxpayer. For the purposes of this section, written advice includes municipal boundary information, and zip codes and addresses located within municipalities provided by the department.

The Department sent a letter to the Robert D. Hofer who was President of the State Bar of South Dakota (Exhibit 2) dated November 20, 1991, which said that photocopy expenses were deductible unless a "mark-up" was charged. Any "mark-up" would be part of the attorney's gross receipts.

[¶18] In September of 1992, the Department published a document called "Attorney Tax Facts" which included the following:

This deduction may only be taken if the amount represents an expense specifically incurred for a particular client and the amount is itemized and separately billed as a reimbursable expense. *The expense must reasonably reflect*

the true cost.” (Emphasis added.)

“Telephone and FAX charges” and “Photocopying fees” are listed as examples of the deductible reimbursable expenses. The Attorney Tax Facts document pointed out that any amount over and above the actual cost on any reimbursable expense would be subject to sales tax. Tax Facts also noted that day to day office expenses were not reimbursable expenses.

[¶19] On September 24, 1997, the Department sent a further letter to Thomas C. Barnett, Secretary-Treasurer of the State Bar Association clarifying that photocopying fees were only reimbursable expenses if they were obtained from an “outside” provider and sales tax is paid to the provider:

As pointed out in ... “Attorneys Tax Facts,” certain expenses are deductible. The expense must result from the purchase of tangible property or services from a third party, on behalf of a specific client, and must not be purchased for resale. The tangible personal property or services that may be entitled to the deduction are ... (4) photocopying fees

You have correctly stated the Department’s position that these transactions are taxable one time by the seller and the attorney is not liable for sales tax on his or her gross receipts. *If the attorney is not charged tax by the seller*, then the attorney must remit tax on the client’s bill. ... (Emphasis added.)

The Department contended that its letters and publication showed that only copies purchased at Kinko’s (or the functional equivalent) were exempt from sales tax when billed to a client as reimbursable expenses. As authority, the 1997 letter cites the Department’s own Tax Fact publication to disqualify “in-house” copies from the exemption. However, the Tax Facts publication and the letters are all self-serving interpretations of the law by the Department. The distinction between “in-house” and “outside” expenses does not appear in the statute, only in the Department’s documents. There is no statute, rule or case cited for the proposition that only “outside” copies made at Kinkos are exempt. Saying it is so does not make it so.

[¶20] Even assuming that the department is correct that the expenses must be incurred with “outside” providers, the Law Firm only computed the cost of equipment, repairs, paper, toner and supplies purchased from outside vendors in the cost of the copies billed to the clients. Sales tax was charged by each of the vendors of the supplies. The Law Firm did not include any “in-house” or “overhead” expenses such as use of office space or employee time expended in making copies. There was no “mark-up” on the copies.

[¶21] Perversely, after depending on the logic in its letters, the Department maintained that the Law Firm could not rely on favorable portions of the letters sent to the State Bar Association because the letters were not sent directly to the Law Firm. Instead of sending several hundred individual letters to several hundred lawyers, the Department sent one letter to the State Bar Association as a convenient way to inform attorneys about information from the Department of Revenue. State Bar members should be able to rely on sales tax information sent by the Department to the State Bar Association.

Conclusion

[¶22] The flat fees charged for long distance phone calls, faxes, and photocopies were specifically incurred for a particular clients and itemized and billed separately as a reimbursable expense. The Law Firm did not make a profit on the reimbursed expenses. Therefore, the Department the long distance phone calls, faxes and copies were reimbursable expenses exempt from sales tax. The Department is reversed.

[¶23] Mr. Theeler shall submit proposed findings of fact and conclusions of law and a proposed judgment and Mr. Hageman shall submit objections and proposed findings of fact and conclusions of law and a proposed judgment in accordance with the rules of procedure.

Endnotes

1. \$5 for breakfast, \$9 for noon lunch, \$12 for dinner and \$2 for evening supper up to \$26 per day.
2. An argument passes the straight-face test if it is one which a competent and ethical lawyer can make while maintaining a straight face. In re Delbridge, 61 BR 484, 486 n.1 (BkyEDMich 1986).