

LAW WEEK

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Wheeler Trigg O'Donnell Gets Millions in Tax Liability Reversed for IBM

Court finds Golden erred in two separate audits

BY JULIA CARDI
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Wheeler Trigg O'Donnell recently represented IBM in a Denver bench trial against the City of Golden that resulted in the court invalidating certain tax assessments on IBM from 2006 to 2012 and also nullifying a 50 percent penalty. In the decision, Denver District Court Judge John Madden wrote a judgment from previous litigation in Jefferson County court about a tax assessment from 2003 to 2005 did not preclude IBM from litigating this case's issues, because the Jefferson County court based its previous decision on IBM's failure to provide information.

"This is a recurring issue," said WTO president Hugh Gottschalk, who represented IBM along with Pawan Nelson. "The money that Xcel pays to IBM for its contract services... is a repeating thing, and so if it is ultimately concluded, it has recurring significance. It's about getting the law and the taxability of these payments right, both for this time period and for current and future time periods."

In an email through a city spokesperson, Golden's finance director Jeff Hansen declined comment beyond saying the city is "disappointed with the decision." He confirmed the city will decide in a July 26 executive session with City Council whether to appeal the judgment.

According to the judgment, the case arose from IBM's business relationship with Xcel Energy, in which Xcel and its predecessor companies have outsourced their information technology department to IBM since 1995. IBM provides services to Xcel in multiple states and data centers, including Golden. Fees paid to IBM by the energy company include "fixed management fees," "variable charges," and "pass through" charges. In exchange for the fixed management fees and variable charges, IBM does not sell any tangible personal property, equipment, hardware or software to Xcel.

By contrast, pass-through transactions fell outside of the regular IT services agreement between Xcel and



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IBM. In such a situation, the parties would enter into a contractual Statement of Work defining the new project's scope and the associated fees. The fees were treated as pass-through transactions and listed separately from the fixed management fees and variable charges.

In the judgment, the court found Golden city auditor Ken Keeley erred when he classified certain services provided to Xcel by IBM as taxable telecommunications services. Keeley also erred, the court found, when he assessed sales taxes to IBM on some fixed management fees and variable charges when in fact, IBM had not sold any tangible personal property, equipment, hardware or software as part of those transactions and they should not have been taxable.

In the July 1 judgment, the court invalidated tax assessments resulting from two audits Golden conducted of IBM, one spanning tax years 2006 to 2008 and the other 2009 to 2012. IBM had appealed the assessments to the Colorado Department of Revenue, which concluded the challenge was precluded due to the outcome of litigation of a tax assessment from a 2003 to 2005 audit of IBM. The Department of Revenue concluded the

IT services agreement at issue in the present case was substantially similar to the one that covered the earlier period.

The Denver District Court disagreed with the department's finding based on the doctrine of issue preclusion. The court also disagreed with Keeley's conclusion during his audit that IBM's sales journal was unreliable because of the inaccurate recordings of a few details about select transactions. The court disagreed with Keeley's decision to subsequently rely on IBM's chargeback database, rather than its sales journal and purchase journal, to estimate the company's tax liability.

According to a news release posted to WTO's website, Golden attempted to recover a total of \$6.1 million from IBM, which included a 50 percent penalty assessed by the Department of Revenue for sales and use tax delinquency from the 2006 to 2008 and 2009 to 2012 audit periods.

IBM voluntarily conceded tax liability of \$24,307.54 for several pass-through transactions, and the court found an additional liability of \$8,588.59. The court vacated the remainder of the assessed taxes spanning from 2006 to 2012, as well as the

50 percent liability.

The court found Golden improperly assessed taxes on IBM from the 2009 to 2012 audit because the audit was not based on any actual audit work. Instead, Golden assessed the taxes based on the 2006 to 2008 audit findings, because Keeley left his position with Golden and Hansen instructed him to issue an assessment rather than assign the audit to another city auditor.

"No audit work was actually conducted during the 2009-2012 Audit," states the court's judgment. "Furthermore, IBM was not given an adequate opportunity to provide information before Golden issued its assessment for the 2009-2012 period."

In a different news release, WTO characterized the case as significant outside Golden as well.

"Golden is not alone among municipalities that take an aggressive approach to taxation," states the release. "The outcome serves as an example for businesses that make good-faith efforts to cooperate with municipalities on taxation issues, yet which will push back hard against the misapplication of tax law when they believe they are being unfairly targeted." •

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—Hugh Gottschalk, commercial litigator