DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 05-0438
Sales and Use Tax
For Tax Period 2001-2002

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Sales and Use Tax-Imposition on Software Maintenance Agreements

Authority: IC § 6-8.1-5-1(b), IC § 6-2.5-2-1(a), IC § 6-2.5-3-2(a), IC § 6-2.5-1-2, Sales Tax Information Bulletin # 2 (May 2, 1983), Sales Tax Information Bulletin # 2 (August 1991), Sales Tax Information Bulletin # 2 (November 2000), Sales Tax Information Bulletin # 2 (May 2002), *Wholesalers, Inc. v. Indiana Department of State Revenue,* 597 N.E.2d 1339 (Ind. Tax 1992).

The taxpayer protests the imposition of use taxes on software maintenance agreements.

II. Sales and Use Tax-Imposition of Sales and Use Tax on Software

Authority: IC § 6-2.5-3-2(a).

The taxpayer protests the imposition of use taxes on software.

III. Tax Administration-Imposition of Negligence Penalty

Authority: IC § 6-8.1-10-2.1, 45 IAC 15-11-2(b), 45 IAC 15-11-2(c).

The taxpayer protests the imposition of the negligence penalty.

STATEMENT OF FACTS

The taxpayer is a corporation engaged in the insurance business. After an audit, the Indiana Department of Revenue, hereinafter referred to as the "department," assessed additional sales and use taxes, penalty, and interest against the taxpayer. The taxpayer protested the assessment of use tax on several software maintenance agreements, the assessment of use tax on a software agreement, and the negligence penalty. A hearing was held and this Letter of Findings results.

I. Sales and Use Tax-Imposition on Software Maintenance Agreements

DISCUSSION

During the tax period, the taxpayer purchased several software maintenance agreements. The department assessed use tax on these software maintenance agreements. The taxpayer protested the assessments. The specific items protested by the taxpayer include the software maintenance agreements represented by Exhibits A, B, C, E, F, G, H, I, J, K, L, M, and N. Each of those maintenance agreements specify that updates may be provided. There is no guaranteed certainty that any updates will be provided. The taxpayer argues that because there is no guaranteed delivery of tangible personal property for the fees charged for the maintenance of the software, there is no sale of tangible personal property subject to the Indiana sales or use tax.

Notices of proposed assessments are prima facie evidence that the department's claim for unpaid taxes is valid**.** IC § 6-8.1-5-1(b). The taxpayer has the burden of proving that the department incorrectly imposed the assessment. Id.

IC § 6-2.5-2-1(a) imposes sales tax on retail transactions made in Indiana. IC § 6-2.5-3-2(a) imposes a complementary excise tax, the use tax, on the storage, use or consumption of tangible personal property in Indiana, if the property was acquired in a retail transaction as defined for sales tax purposes, regardless of the location of that transaction. A "retail transaction" is defined in IC § 6-2.5-1-2 as a transaction that constitutes "selling at retail...."

IC § 6-2.5-4-1(b) states that a person is engaged in "selling at retail" when:

In the ordinary course of his regularly conducted trade or business, he:

(1) Acquires tangible personal property for the purpose of resale; and

(2) Transfers the property to another for consideration.

There is no regulation that sets out the department's position regarding the application of sales and use tax to optional warranties. The department first issued Sales Tax Information Bulletin # 2 concerning Optional Warranties or Dealer on May 2, 1983. In that Information Bulletin, the department explained that if there was a possibility that no tangible personal property would be transferred with the warranty, then there was no certainty that there would be a retail sale and the sales and related use tax did not apply. This position was restated in the revised Sales Tax Division Information Bulletins issued in August 1991, November 2000, and May 2002. Each of the revisions restated the general rule. In the May 2002 revision, it was stated "[o]ptional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax." Each of the revisions also gave a specific example concerning computer software situations. The examples stated that sales and use tax would apply to the sale of an optional warranty or maintenance agreement in the software situation *only if* there was a guarantee of the transfer of tangible personal property (updates)

pursuant to the agreement.

Computer technology and use has evolved since the issuance of the first Sales Tax Information Bulletin # 2 on May 2, 1983. Almost all software optional warranties and software maintenance agreements sold today include the automatic provision of updates-sometimes on a day-by-day or week-by-week basis. Purchasers of these agreements have a reasonable expectation that they will receive the updates whether or not the actual contract couches the provision of updates as "optional." The substance of the agreements is that tangible personal property in the form of software updates will be provided no matter what the language of the contract says. The department determines tax consequences by construing the substance of the agreement over the form. *Wholesalers, Inc. v. Indiana Department of State Revenue,* 597 N.E.2d 1339 (Ind. Tax 1992). In the case of software maintenance agreements or optional warranties, it is clear that the parties presume that tangible personal property in the form of updates will be transferred. Therefore, the department will construe software maintenance agreements and optional agreements as presumed to be subject to the sales and use tax. A taxpayer could rebut this presumption by demonstrating that no updates were actually received pursuant to a particular maintenance agreement or optional warranty.

In this particular taxpayer's situation, the department will apply this interpretation prospectively.

FINDING

The taxpayer's protest is sustained as to the maintenance agreements and optional warranties in this assessment. The taxpayer is advised that in the future, there will be a rebuttable presumption that all software maintenance agreements and optional warranties will be subject to the sales and use taxes.

II. Sales and Use Tax-Imposition of Sales and Use Tax on Software

DISCUSSION

Every day the taxpayer is required to transmit individuals' investment actions to certain mutual funds and collective investment funds. The taxpayer has a computerized system to accomplish this. The department assessed use tax on the taxpayer's use of this system pursuant to IC § 6-2.5-3-2(a). The taxpayer protested this imposition of use tax arguing that the system actually constituted the provision of a non taxable service.

The contract at issue here includes the following language:

[Vendor] shall install and maintain a software interface (the "Interface") on a personal computer designated by the User and located a the User's designated facility. The maintenance of the Interface shall include the installation of upgrades, as available.

This language makes it clear that the taxpayer purchased and used a canned software program to transmit the investors' transactions. The use of canned software programs is subject to the use tax if sales tax was not paid at the time of purchase. There is no indication that the taxpayer paid sales tax when it purchased the canned software program. Therefore, the department properly assessed use tax on the canned software program.

FINDING

The taxpayer's protest is denied.

III. Tax Administration- Ten Percent Negligence Penalty

DISCUSSION

The taxpayer protested the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.
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> The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:
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> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
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> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The taxpayer provided substantial documentation to indicate that its failure to pay the assessed use tax was due to reasonable cause rather than negligence.

FINDING

The taxpayer's protest is sustained.

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An html version of this document.