DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 07-0051
Sales and Use Tax
For the Tax Period 2003 - 2005

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ISSUES

I. Sales and Use Tax – Imposition on Computer Software.

Authority: IC § 6-8.1-5-1(c); IC § 6-2.5-2-1; IC § 6-2.5-3-2(a); IC § 6-2.5-1-24; Sales Tax Information Bulletin 8 (May, 2002); *Indiana Dep't of State Revenue v. Interstate Warehousing,* 783 N.E.2d 248 (Ind. 2003).

The Taxpayer protests the imposition of use tax on computer software.

II. Sales and Use Tax – Imposition on Services.

Authority: IC § 6-8.1-5-1(c); IC § 6-2.5-2-1; IC § 6-2.5-3-2(a); IC § 6-2.5-4-1(b); IC § 6-2.5-1-1(a).

The Taxpayer protests the imposition of use tax on services.

III. Sales and Use Tax – Imposition on Contracts for Improvements to Real Estate.

Authority: IC § 6-2.5-3-2(a); IC § 6-2.5-4-9; IC § 6-2.5-5-8(b); 45 IAC 2.2-4-26; *Ochs v. Tilton*, 181 Ind. 81, 103 N.E.2d 837 (1914).

The Taxpayer protests the imposition of tax on contracts for improvements to real estate.

IV. Tax Administration - Ten Percent Negligence Penalty.

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

The Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

The Taxpayer is a Rural Electric Membership Corporation that provides electricity, merchandise, telephone service, and internet service to residents of several Indiana counties. The Indiana Department of Revenue (Department) audited the Taxpayer for the years 2003-2005. As a result of this audit, the Department assessed additional sales tax, use tax, interest, and penalty. The Taxpayer protested the assessments of sales tax, use tax, and penalty. Prior to the hearing, several items were agreed to. Those items include asset issues with reference #7738, #6836, #6221, #8642, #8839, #10301, #11989. Expense items agreed to included stratum #2-item #35, stratum #2-item #162, stratum #2-item #230, stratum #3-item #278. A hearing on the remaining issues was held. This Letter of Findings results.

I. Sales and Use Tax – Imposition on Computer Software.

DISCUSSION

During the tax period, the Taxpayer purchased computer software that allowed its customers to access their account information and pay their bills online. The Taxpayer paid for this software in installments during 2003 and 2004. The Department considered the software to be canned pre-written software subject to the sales and use tax. The Taxpayer protested this assessment. The Taxpayer argued that the software was custom made and not subject to the Indiana sales and use tax.

All tax assessments are presumed to be valid. IC § 6-8.1-5-1(c). The Taxpayer bears the burden of proving that any assessment is incorrect. *Id*. Exemption statutes are to be strictly construed against taxpayers. *Indiana Dep't of State Revenue v. Interstate Warehousing,* 783 N.E.2d 248, 250 (Ind. 2003).

Indiana imposes a sales tax on the transfer of tangible personal property in a retail transaction. IC § 6-2.5-2-1. Indiana imposes a complementary excise tax, the use tax, on tangible personal property stored, used, or consumed in Indiana. IC § 6-2.5-3-2(a).

During the tax year 2003, the Department's policy towards the sales and use taxability of computer software was stated in Sales Tax Information Bulletin #8 (May, 2002) as follows:

> II.B. Transactions Involving Computer Software:
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> As a general rule, transactions involving computer software are not subject to Indiana Sales or Use Tax provided the software is in the form of a custom program specifically designed for the purchaser.
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> Pre-written programs, not specifically designed for one purchaser, developed by the seller for sale or lease on the general market in the form of tangible personal property and sold or leased in the form of tangible personal property are subject to tax irrespective of the fact that the program may require some modification for a purchaser's particular computer. Pre-written or canned computer programs are taxable because the intellectual property contained in the canned program is no different than the intellectual property in a videotape or a textbook.

In 2003, the Indiana Legislature enacted legislation to codify the Department's position concerning the taxability of computer software. As of January 1, 2004, Indiana law defined "prewritten computer software" at IC § 6-2.5-1-24 as follows:

> Subject to the following provisions, "prewritten computer software" means computer software, including prewritten upgrades, that is not designed and developed by the author or other creator to the specifications of a specific purchaser:
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> (1) The combining of two (2) or more prewritten computer software programs or prewritten parts of the programs does not cause the combination to be other than prewritten computer software.
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> (2) Prewritten computer software includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than the purchaser.
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> (3) If a person modifies or enhances computer software of which the person is not the author or creator, the person is considered to be the author or creator only of the person's modifications or enhancements.
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> (4) Prewritten computer software or a prewritten part of the software that is modified or enhanced to any degree, where the modification or enhancement is designed and developed to the specifications of a specific purchaser, remains prewritten computer software. However, where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such a modification or enhancement, the modification or enhancement is not prewritten computer software.

The statutory definition of "pre-written" or "canned" software includes many elements to consider in determining whether or not particular software was designed and developed to meet the requirements of a particular customer. The Taxpayer's bill presentment software allowing customers to review their bills and pay them online was based on an Oracle program platform. Under IC § 6-2.5-1-24(3), then, the software started with a canned program. Therefore, only modifications and enhancements specifically designed for the Taxpayer could be considered custom software.

IC § 6-2.5-1-24(1) states that combinations of pieces of canned software result in a total piece of software that is prewritten. The software provider has written similar programs for other REMCs and this particular program was prepared for three REMCs in Indiana. Any elements that were part of programs used for other REMCs would be considered pre-written or canned. The rearrangement and combination of these canned elements would constitute pre-written or canned software rather than custom designed software. The Taxpayer was unable to sustain its burden of proving that the program prepared for the Taxpayer did not combine elements of the similar programs the contractor built for other REMCs.

Furthermore, under IC § 6-2.5-1-24(4), even modifications to pre-written canned software are not considered custom unless there is a reasonable separate charge. The Taxpayer was unable to prove that there were separate billings for any substantial software modifications or enhancements specific to the Taxpayer's needs.

The subject software program met the Department's definition of canned software that was enacted into legislation effective January 1, 2004. The Taxpayer failed to sustain its burden of proving that the bill presentment software which it purchased during 2003 and 2004 was custom made software exempt from the sales and use tax.

FINDING

The Taxpayer's protest is respectfully denied.

II. Sales and Use Tax – Imposition on Services.

DISCUSSION

The Department originally assessed use tax on the total value of two contracts as unitary transactions. The first contract was with a tree service that cleared trees and brush. The second contract was for processing and mailing billing statements with return envelopes to customers. The Taxpayer protested these assessments contending that each contract represented a non-taxable service. Upon review, the Department deleted its assessment on the labor portions of the contracts. The Department's supplemental workpapers assessed use taxes only on the materials.

Indiana imposes sales tax on retail transactions made in Indiana. IC § 6-2.5-2-1(a). Indiana imposes a complementary 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. IC § 6-2.5-3-2(a). A "retail transaction" is defined as the transfer of tangible personal property for consideration by a retail merchant. IC § 6-2.5-4-1(b). The provision of services is not the transfer of tangible personal property. Therefore, services are not subject to the imposition of the sales and use tax unless the law specifically defines the provision of the particular services as a taxable retail transaction.

A "unitary transaction" is defined at IC § 6-2.5-1-1(a) as follows:

> "[U]nitary transaction" includes all items of personal property and services which are furnished under a single order or agreement and for which a total combined charge or price is calculated.

The Taxpayer argued that it had contracts for the performance of services by a mailing service and tree service. Each of the contracts on which use tax was assessed was called "services." Just because a contract is called a contract for services, does not make the product sold a service for sales and use tax purposes. The tree service sold the Taxpayer significant amounts of chemicals that the tree service used in clearing the brush and trees. The billing processing and mailing service also sold the Taxpayer significant amounts of tangible personal property in the form of printed papers and envelopes. Since significant amounts of tangible personal property passed with the contracts along with the services, the contracts were not merely contracts for the provision of

services.

Pursuant to the statutory definition, services are subject to the sales and use tax when they are provided in conjunction with personal property as a unitary transaction. To determine whether or not the contracts with the tree service and mailing service were unitary transactions it is necessary to consider if the services and tangible personal property were "furnished under a single order or agreement and for which a total combined charge or price is calculated." In Taxpayer's situation, the invoices for the tree services and mailing services separated the costs of labor from the costs of the materials. This separation of the costs of materials from labor indicated that the Taxpayer contracted for the purchase of tangible personal property and the provision of services. Therefore, the transactions were not unitary transactions.

The Department properly adjusted its assessment with the supplemental workpapers prior to the hearing by deleting the use tax assessment on the labor. The supplemental assessment which assessed use tax only on the materials used in the fulfillment of the contracts is correct.

FINDING

The Taxpayer's protest to the supplemental assessment is respectfully denied.

III. Sales and Use Tax – Imposition on Contracts for Improvements to Real Estate.

DISCUSSION

The Department assessed use tax on the materials used in the construction of underground electrical lines and the total cost of the contract for the construction of an electrical substation pursuant to IC § 6-2.5-3-2(a). The Taxpayer protested these assessments. The Taxpayer argued that it was not liable for use tax since the contractors paid sales tax on the supplies used in the construction.

IC § 6-2.5-4-9 deals with the sales and use tax liability in construction situations as follows:

(a) A person is a retail merchant making a retail transaction when the person sells tangible personal property which:

(1) is to be added to a structure or facility by the purchaser; and

(2) after its addition to the structure or facility would become a part of the real estate on which the structure or facility is located.

The sales and use tax liability in construction situations is clarified at 45 IAC 2.2-4-26 as follows:

(a) A person making a contract for the improvement to real estate whereby the material becoming a part of the improvement and the labor are quoted as one price is liable for the payment of sales tax on the purchase price of all material so used.

(b) A person selling tangible personal property to be used as an improvement to real estate may enter into a completely [sic] separate contract to furnish the labor to install or construct such improvement, in which case the sales tax shall be collected and remitted by such seller on the materials sold for this purpose. Such sales of materials must be identifiable as a separate transaction from the contract for labor....

In the first protest concerning a contract for construction, the contractor renovated underground conduits for wires. This contract was a time and materials contract. The Department only assessed sales tax on the charges for the materials. Pursuant to the law and regulations, the seller, the contractor in this case, is to collect and remit sales tax on the materials portion of any time and materials contract. The seller failed to do so in this case. Therefore, the Department properly assessed use tax on the materials portion of the contract to the purchaser, the Taxpayer in this case. The Taxpayer presented a statement from the contractor indicating that the contractor paid sales tax when it purchased the materials used in the renovation of the underground conduits. If that is truly the case, the contractor incorrectly paid sales tax on tangible personal property that qualified for the exemption for tangible personal property purchased for resale pursuant to IC § 6-2.5-5-8(b). If the statute of limitations has not run, the contractor has the remedy of applying for a refund of sales taxes improperly paid.

The second protest to sales tax on a construction contract concerns a lump sum contract. The Taxpayer contracted with and paid a contractor to construct an electrical substation. The Department considered the electrical substation to be tangible personal property. Therefore the lump sum contract for the construction of the electrical substation was subject to the sales tax. The Taxpayer protested this assessment. The Taxpayer considered the transaction a lump sum contract for the construction of an improvement to realty and not subject to the sales tax.

The issue to be determined is whether the electrical substation is tangible personal property or is a fixture that became part of the real estate.

The Department concluded that the electrical substation was tangible personal property rather than a fixture because the electrical substation was similar to a transmission tower. Transmission towers are subject to personal property tax rather than real estate tax. However, the categorization of property for the purposes of real estate taxes is not determinative in this situation.

The test to determine whether personal property used in connection with real estate is to be considered tangible personal property or a fixture is stated in *Ochs v. Tilton* 181 Ind. 81, 85; 103 N.E.2d 837,838 (1914) as follows:

A general rule, recognized by the weight of authority, is that the true test of a fixture requires the united application of the following requisites: (1) annexation of the article which may be either actual or constructive;

(2) adaptation to the use of the realty, or part thereof, with which the article is connected; (3) the party annexing must have intended thereby to make the article a permanent accession to the freehold. *See* 11-352 Midwest Transaction Guide § 352.23 (Matthew Bender 2007)

The electrical substation meets the first element of the test because it was actually attached to the ground by being bolted to concrete bases and footings.

The second element of the test concerns the adaptation of the electrical substation to the ground to which it was annexed. In this case, the electrical substation was well suited and adapted to the land in that the area immediately surrounding the electrical substation is grassland with trees at the edges of the grass. The substation does not interfere with buildings, farming, or any other uses of the land. The substation cannot be easily removed if the Taxpayer decides to use the land for another purpose. The electrical substation meets the second element of the test to be considered a fixture that became part of the real estate.

Finally, to qualify as a fixture, the Taxpayer must have intended to make the electrical substation a permanent addition to the land. To determine the Taxpayer's intention, the Department must look at all the circumstances surrounding the installation of the electrical substation. In this case, the Taxpayer owned the land in fee simple on which the electrical substation was built. The Taxpayer placed the electrical substation in that location after study of the electrical needs of cooperative members now and for the foreseeable future. The Taxpayer also conducted a cost analysis of the various methods of meeting those needs. Further, since its founding in 1938, the Taxpayer has only moved an electrical substation on one occasion. These circumstances surrounding the installation of the electrical substation indicate that the Taxpayer intended for the electrical substation to be a fixture permanently attached to the land so that the Taxpayer could continue to furnish the electrical needs of its association members.

The electrical substation satisfied each of the elements of the test set out by the court to determine whether or not personal property is transformed into a fixture attached to the real estate. In this case, the Taxpayer had a lump sum contract with a construction firm to add an improvement to real estate which it owned. Therefore, there is no sales tax or use tax due on the transaction by the Taxpayer. The contractor was liable for sales or use tax on the materials used in building and installing the electrical substation.

FINDING

The Taxpayer's protest to the assessment of use tax on the materials used in renovating the underground electrical conduit is respectfully denied. The Taxpayer's protest to the assessment of use tax on the lump sum contract for the building of the electrical substation on the Taxpayer's property is sustained.

IV. Tax Administration - **Ten Percent Negligence Penalty.**

DISCUSSION

The Taxpayer protests 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.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

> 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 to the imposition of the penalty is sustained.

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