DEPARTMENT OF STATE REVENUE

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Letter of Findings: 10-0094
Sales Tax
For the Years 2007 and 2008

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ISSUE

I. Sales Tax – Imposition – Maintenance Agreements.

Authority: IC § 6-8.1-5-1; § 6-2.5-1-1; IC § 6-2.5-1-2; IC § 6-2.5-2-1; IC § 6-2.5-4-1; 45 IAC 2.2-4-2; Sales Tax Information Bulletin 2 (December 2006); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Allied Collection Service v. Ind. Dep't of State Revenue, 899 N.E.2d 69 (Ind. Tax Ct. 2008); Cowden & Sons Trucking, Inc. v. Ind. Dep't of Revenue, 575 N.E.2d 718 (Ind. Tax Ct. 1991).

Taxpayer protests the imposition of sales tax on its sale of maintenance agreements.

STATEMENT OF FACTS

Taxpayer is a retail merchant that provides business machines and equipment to its customers. Taxpayer's gross receipts consist of rental income, sales of typewriters, copiers, office supplies, furniture, computers, registers, fax machines, and maintenance agreements. Taxpayer provides maintenance and repair services consisting of parts and labor. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer for the years 2007 and 2008. Taxpayer's daily cash receipts were examined with no material discrepancies. Sales invoices were examined and the Department's audit found that Taxpayer sold maintenance agreements to non-exempt customers, but did not charge sales tax. The Department's audit assessed additional sales tax on Taxpayer's sale of maintenance agreements and interest. Taxpayer protests the assessment of additional sales tax. A hearing was held and this Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales Tax – Imposition – Maintenance Agreements.

DISCUSSION

The Department assessed sales tax on all the maintenance agreements Taxpayer sold to non-exempt customers pursuant to Sales Tax Information Bulletin 2 (December 2006) which sets out the Department's application of IC § 6-2.5-4-1 and 45 IAC 2.2-4-2. The Department's proposed assessments for the years at issue gave Taxpayer credit for sales tax Taxpayer had collected from some customers (which will be further explained below). Taxpayer protests the Department's proposed assessment arguing that it organized its tax affairs pursuant to the recommendations of a prior audit and case law.

The majority of Taxpayer's agreements relate to maintenance of copiers that Taxpayer leases to its customers. The agreements fall into two categories. All the maintenance agreements state that "service checks, preventive maintenance calls, intervening service calls, travel time, replacement parts and service labor" are included in the agreement. (Emphasis added). Some of the agreements state that " supplies, such as toner, developer/starter, silicon/fuser oil, or photoconductor drum are not included." (Emphasis added). These agreements are referred to as "Agreements w/out Supplies." In contrast, the other category of agreements includes supplies. These agreements are referred to as "Agreements w/ Supplies."

For the years at issue, Taxpayer charged its customers a flat fee for the "Agreements w/out Supplies" but did not collect sales tax on the sale of the agreement. However, if Taxpayer provided supplies (such as toner) in servicing a customer's copier under one of these agreements, Taxpayer charged the customer for the supplies and collected sales tax on those items at the time of the service.

On the other hand, for the "Agreements w/ Supplies," Taxpayer broke down the annual agreement fee into two charges, one for "Labor" (which mirrored the charges for the "Agreements w/out Supplies") and one for "Toner and Drum"; i.e., supplies. Taxpayer did not collect sales tax on the "Labor" fee, but Taxpayer did collect sales tax on the charge relating to "Toner and Drum." If Taxpayer used supplies in servicing a customer's copier under one of these agreements, Taxpayer did not charge the customer for the supplies since Taxpayer was already covered under the agreement. The Department's audit gave Taxpayer credit for the sales tax Taxpayer collected upfront on the portion of the agreements that related to the Toner and Drum fee.

Under either type of agreement, if Taxpayer happened to use replacement parts (for example, screws or other minor components – in contrast to supplies) in the course of providing maintenance service, Taxpayer did not charge its customers for those items, but rather remitted use tax itself to the Department.

The Department notes that all tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1 (c); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

An excise tax, known as the state gross retail tax (sales tax), is imposed on retail transactions made in

Indiana. IC § 6-2.5-2-1. A taxable retail transaction is "a transaction of a retail merchant that constitutes selling at retail as described in IC § 6-2.5-4." IC § 6-2.5-1-2(a). Selling at retail requires a transfer of tangible personal property. IC § 6-2.5-4-1(b)(2). Since a service does not constitute tangible personal property, the sale of services usually falls outside the scope of the gross retail tax. In "mixed transactions" - i.e., those transactions where tangible personal property is sold in order to complete a service contract, or where services are preformed in order to complete the sale of tangible personal property – it is often difficult to distinguish between the taxable sale of property and the non-taxable sale of services. Allied Collection Service v. Ind. Dep't of State Revenue, 899 N.E.2d 69 (Ind. Tax Court 2008), most recently summarized the parameters of analysis of "mixed transactions" as follows:

> [T]he legislature has set forth several parameters for imposing tax on these transactions. First, taxable property does not escape taxation merely because it is transferred in conjunction with the provision of non-taxable services. A.I.C. § 6-2.5-4-1(c)(2). Second, services, generally outside the scope of taxation, are subject to tax to the extent the income represents "any bona fide charges which are made for preparation, fabrication, alteration, modification, finishing, completion, delivery, or other service performed in respect to the property transferred before its transfer and which are separately stated on the transferor's records." A.I.C. § 6-2.5-4-1(e)(2). Finally, services are also subject to tax if they are provided in the course of a retail unitary transaction, "a unitary transaction that is also a retail transaction." Ind. Code Ann. § 6-2.5-1-2(b) (West 2003). A unitary transaction is a transaction that "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." Ind. Code Ann. § 6-2.5-1-1(a) (West 2003) (emphasis added).
> Id. at 72.

Therefore, there are two instances when an otherwise non-taxable sale of a service is subject to sales tax. The first is when the services are performed with respect to tangible personal property being transferred in a retail transaction and the services take place prior to the transfer of the tangible personal property. IC § 6-2.5-4-1(e). The second is when the services are part of a retail unitary transaction. IC § 6-2.5-1-2. A unitary transaction is defined as a transaction that includes the transfer of tangible personal property and the provision of services for a single charge pursuant to a single agreement or order. IC § 6-2.5-1-1. A retail unitary transaction is a unitary transaction that is also a retail transaction.

45 IAC 2.2-4-2 elaborates:

> (a) Professional services, personal services, and services in respect to property not owned by the person rendering such services are not "transactions of a retail merchant constituting selling at retail", and are not subject to gross retail tax. Where, in conjunction with rendering professional services, personal services, or other services, the serviceman also transfers tangible personal property for a consideration, this will constitute a transaction of a retail merchant constituting selling at retail unless:
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> (1) The serviceman is in an occupation which primarily furnishes and sells services, as distinguished from tangible personal property;
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> (2) The tangible personal property purchased is used or consumed as a necessary incident to the service;
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> (3) The price charged for tangible personal property is inconsequential (not to exceed 10 [percent]) compared with the service charge; and
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> (4) The serviceman pays gross retail tax or use tax upon the tangible personal property at the time of acquisition.
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> (b) Services performed or work done in respect to property and performed prior to delivery to be sold by a retail merchant must however, be included in taxable gross receipts of the retail merchant.
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> (c) Persons engaging in repair services are servicemen with respect to the services which they render and retail merchants at retail with respect to repair or replacement parts sold.
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> (d) A serviceman occupationally engaged in rendering professional, personal or other services will be presumed to be a retail merchant selling at retail with respect to any tangible personal property sold by him, whether or not the tangible personal property is sold in the course of rendering such services. If, however, the transaction satisfies the four (4) requirements set forth in 6-2.5-4-1(c)(010), paragraph (1) [subsection (a) of this section], the gross retail tax shall not apply to such transaction.

Taxpayer cites to Cowden & Sons Trucking, Inc. v. Ind. Dep't of Revenue, 575 N.E.2d 718 (Ind. Tax Ct. 1991) where the court stated that "the legislature intends to tax services rendered in retail unitary transactions only if the transfer of property and the rendition of services is inextricable and indivisible." Id. at 722 (citing Ind. Dep't of Revenue v. Martin Marietta Corp. 35 N.E.2d 1309, 1313 (Ind. Ct. App. 1979).

In Cowden a trucking company, having engaged in certain transactions in which it transported stone, was assessed sales tax on the value of the transportation services. Ninety-five percent of the taxpayer's customers were contractors that engaged Cowden exclusively for its hauling services and where the customers paid the quarries directly for the stone Cowden hauled. Id. at 719. The remaining 5 percent of Cowden's customers were non-contractors who did not have existing accounts with the quarries, as a result Cowden paid for the stone at the quarry, including sales tax, and the non-contractor customer reimbursed Cowden. Id. The Department argued that the service costs were taxable because Cowden had entered into a unitary transaction which included hauling

services and the sale of stone. The court disagreed, finding that the sale of the stone was not inextricable and indivisible from the transportation services. The court stated that the issue should be resolved by discerning Cowden's intent and that evidence supported Cowden's "assertion that the acquisition of stone was for the convenience and accommodation of its customers, incidental to its hauling services and not for the purposes of resale." Id. at 721. The court found that the sale of the stone was one transaction and the provision of the services was a second, severable transaction and that the second transaction was not subject to the sales tax. Id. at 722. The court found relevant the fact Cowden did not maintain an inventory of stone to sell to its customers, did not advertise the sale of stone, and did not hold itself out as a stone merchant. Id. at 721. In addition, Cowden – because it merely charged its customers for the cost of the stone – had no profit motive in selling stone to its customers and that transfer of stone was entirely incidental to Cowden's provision of transportation services. Id. at 721-722.

Taxpayer relies on Cowden to support the proposition that services may be provided to a customer in which the transfer of tangible personal property is entirely incidental to the provision of the services. Taxpayer is correct. The court found that Cowden was in the business of providing transportation services. Cowden owned equipment for the provision of those services and did not maintain an inventory of stone. Cowden did not advertise for the sale of stone and did not hold itself out as a stone merchant. Ninety-five percent of Cowden's customers sought out Cowden for its hauling services. On occasion, Cowden purchased stone on behalf of its customers "merely for the convenience of its... customers." Id. at 721.

The facts in Cowden, however, stand in contrast to the facts of this protest. In this instance Taxpayer is a retail merchant in the business of selling office equipment and furniture and is not primarily a service provider. Also, at issue here are maintenance agreements that contemplate the transfer of tangible personal property in the form of replacement parts and supplies through the duration of the agreement.

Sales Tax Information Bulletin 2 (December 2006, replacing the bulletin dated May 2002) explains the application of the sales and use tax to tangible personal property transferred pursuant to (1) original warranties or dealer warranties, or (2) optional warranties and maintenance agreements. The Information Bulletin states in relevant part:

> Optional warranties and maintenance agreements that also contain provisions for periodic services where tangible personal property will be supplied as a part of the unitary price fall within the ambit of Rule 45 IAC 2.2-4-2. This Rule, interpreting IC 6-2.5-4-1, states that where**,** in conjunction with rendering services**,** a service provider also transfers tangible personal property for a consideration, this will constitute a retail transaction unless:
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> 1. The service provider is in an occupation that primarily furnishes and sells services, as distinguished from tangible personal property;
> 2. The tangible personal property is used or consumed as a necessary incident to the service;
> 3. The price charged for the tangible personal property is inconsequential (not to exceed 10 percent) compared with the service charge; and
> 4. The service provider pays sales tax or use tax upon the tangible personal property at the time of acquisition.
>
> IC 6-2.5-2-1 imposes the state gross retail tax on retail transactions made in Indiana. If the provisions contained in the warranties or agreements are in complete compliance with all provisions of Rule 45 IAC 2.2-4-2, then the periodic transfer of tangible personal property will not constitute a transaction of a retail merchant constituting selling at retail. If such is the case, the service provider is not obligated to collect sales tax on the unitary price of the warranties or maintenance agreements. However, the service provider of the parts or property will be liable for the use tax on the parts or property because the service provider is using the material to fulfill the service called for by the terms of the warranty or maintenance agreement.
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> If the provisions contained in the warranties or agreements are not in complete compliance with all provisions of Rule 45 IAC 2.2-4-2, this will constitute a transaction of a retail merchant selling at retail. Thus, the service provider must collect sales tax on the unitary price pursuant to IC 6-2.5-2-1. Any tangible personal property subsequently transferred to the buyer under the terms of the warranty or maintenance agreement is not subject to sales tax.
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> In the case of software maintenance agreements or optional warranties, the presumption is that tangible personal property in the form of updates will be transferred. Software maintenance agreements and optional warranties are presumed to be subject to sales and use tax. This presumption can be rebutted if the taxpayer can demonstrate that no updates were actually received. Examples:
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> [...]
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> 5. An office supply company sells a photocopy machine to a customer. The customer also purchases an optional maintenance agreement from the company. The maintenance agreement entitles the customer to service and parts at no charge in the event of a breakdown of the photocopying machine. The agreement also provides for quarterly inspections, replacement of the drum after 100,000 copies have been made, and toner to be provided on an as needed basis. The office supply company calculates that the price charged for the above tangible personal property is 35 percent compared with the service charge. The sale

of the maintenance agreement is a transaction of a retail merchant selling at retail and is subject to the collection of sales tax.

(Emphasis added).

According to the Department's audit, Taxpayer had been unaware of the Department's Sales Tax Bulletin 2 that details the requirement for charging sales tax on the sale of maintenance agreements. Taxpayer, pursuant to direction received during a prior audit, collected sales tax on parts it used when it actually performed maintenance per the agreements it sold. For this reason the Department's audit for the years at issue did not recommend that Taxpayer be assessed any penalty. However, Taxpayer is on notice that it has an obligation to be current with sales and use tax laws and any other laws that could impact its business. The Department's website – http://www.in.gov/dor/index/htm - is a convenient place for retailers and their advisors to keep abreast of any changes in the law.

Based on all of the above, Taxpayer should have collected sales tax on the sale of its maintenance agreements, and not just on the "Toner and Drum" portion of the "Agreements w/ Supplies."

FINDING

Taxpayer's protest of the assessment of sales tax on its sale of maintenance agreements is respectfully denied. However, a supplemental audit will ascertain that Taxpayer is given credit for:

(1) sales tax Taxpayer collected and remitted on its sale of the "Toner and Drum" portion of the "Agreements w/ Supplies." (the Department's audit states that it has already accounted for this credit).

(2) sales tax Taxpayer collected and remitted on its sale of supplies at the time it rendered maintenance service under the "Agreements w/out Supplies."

(3) use tax Taxpayer remitted on its use of replacement parts under both categories of agreements if the supplemental audit can ascertain that use tax was indeed remitted.

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