DEPARTMENT OF STATE REVENUE

04-20100650.LOF

Letter of Findings: 04-20100650
Gross Retail Tax
For the Years 2006, 2007, and 2008

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 It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register.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 the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Software Maintenance Agreements – Gross Retail Tax.

Authority: IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-2.5-3-1(a); IC § 6-2.5-3-2(a); Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); Letter of Findings 04-20050438 (August 11, 2006).

Taxpayer argues that it should not have self-assessed use tax on the purchase of software maintenance agreements.

II. Software Services Contracts – Gross Retail Tax.

Authority: IC § 6-8.1-5-1(c); Sales Tax Information Bulletin 8 (May 2002).

Taxpayer maintains that it should not have self-assessed use tax on costs attributable to payments for modifications to computer software programs.

III. Printer Maintenance Agreements – Gross Retail Tax.

Authority: IC § 6-2.5-1-1(a); 45 IAC 2.2-1-1(a); Sales Tax Information Bulletin 2 (May 2002)

Taxpayer states that it should not have self-assessed use tax on costs attributable to printer maintenance agreements.

IV. Pallets – Gross Retail Tax.

Authority: IC § 6-2.5-3-2(a); IC § 6-8.1-8-1.5; IC § 6-8.1-9-2; 45 IAC 2.2-5-16.

Taxpayer argues that the Department's audit failed to give it sufficient credit for the purchase of exempt pallets.

V. Hazardous Waste Disposal – Gross Retail Tax.

Authority: IC § 6-2.5-3-2(a).

Taxpayer maintains that it should not have self-assessed use tax on the cost of a contract for the disposal of hazardous waste.

VI. Purchase for Resale – Gross Retail Tax.

Authority: IC § 6-2.5-5-8(b); Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988).

Taxpayer states that it should not have self-assessed use tax on the purchase of food additive tablets because it purchased the tablets for resale.

VII. Service Contracts – Gross Retail Tax.

Authority: IC § 6-2.5-1-4(a); 45 IAC 2.2-1-1(a).

Taxpayer argues that it should not have self-assessed use tax on the price it paid for various vendors to perform service work at its Indiana location.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of manufacturing and selling medical devices. Taxpayer operates an Indiana distribution center. The Department of Revenue (Department) conducted an audit review of Taxpayer's business records concluding that Taxpayer owed additional sales/use tax. During the course of the audit, the audit noted that, "The taxpayer filed a claim for refund with the Department; however the claim [was not] filed properly." Nonetheless, any Taxpayer overpayment verified during the course of the audit was "netted against" any offsetting liability. The result of this calculation was that any overpayment of tax made during 2008 was offset against the liability for 2006; the remaining amount of verifiable overpayment was offset against the liability for 2007.

Taxpayer submitted a protest. An administrative hearing was conducted during which Taxpayer's representative explained the basis for its protest. This Letter of Findings results.

I. Software Maintenance Agreements – Gross Retail Tax.

DISCUSSION

Taxpayer argues that it should not have self-assessed use tax on the purchase of software maintenance agreements.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). Indiana also imposes a complimentary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that

transaction." IC § 6-2.5-3-2(a). Use means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The use tax is functionally equivalent to the sales tax. See Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

In Letter of Findings 04-20050438 (August 11, 2006), 20061101 Ind. Reg. 045060474NRA, the Department addressed the question of whether "Software Maintenance Agreements" were subject to sales tax. The Department found that these agreements were subject to sales tax on a "prospective basis" as follows:

> 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... 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. (Emphasis added).

The Department's position on this has been consistent; unless a taxpayer can demonstrate that it received no software updates during the term of the maintenance agreement, the Department will presume that the maintenance agreement is subject to sales/use tax. In this case, Taxpayer's first inclination – to self-assess use tax on the purchase of the agreements – was correct because the Department presumes that upgrades will be furnished pursuant to any software maintenance agreement and Taxpayer has not rebutted that presumption.

FINDING

Taxpayer's protest is respectfully denied.

II. Software Services Contracts – Gross Retail Tax.

DISCUSSION

Taxpayer paid a company to update its computer software programs. At the time of the original transaction, Taxpayer self-assessed use tax. Taxpayer now argues that it erred in doing so on the ground that Taxpayer was simply paying for exempt services.

The question of whether or not computer software is subject to sale/use tax is addressed at Sales Tax Information Bulletin 8 (May 2002) 25 Ind. Reg. 3934.

> 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. 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.

As a threshold issue, it is Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

Based on the documentation provided, Taxpayer has met its burden of demonstrating that the amount it paid to "Vendor One" in the amount of $16,500 was for the modification of its existing software package with that vendor. The modification did not provide "[p]re-written or canned computer programs" but was a modification "specifically designed for the purchaser." However, there is nothing to indicate that any of the other transactions

with this company were similarly exempt.

FINDING

Taxpayer is sustained in part and denied in part.

III. Printer Maintenance Agreements – Gross Retail Tax.

DISCUSSION

Taxpayer paid for maintenance agreements. The agreements covered the maintenance of various printers. At the time it paid the vendor, Taxpayer self-assessed use tax. Taxpayer argues that the self-assessment was in error.

The question of whether or not maintenance agreements are subject to use tax was addressed in the Department's Information Bulletin in effect at the time of the relevant transactions.

> Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax. Any parts or tangible personal property supplied pursuant to this type of agreement are subject to use tax. Sales Tax Information Bulletin 2 (May 2002), 25 Ind. Reg. 3595, (Emphasis added).

However, in this case there was nothing in the agreements which distinguished between the amount Taxpayer was paying for printer parts and the amount Taxpayer was paying for labor. Where Taxpayer pays one price for both labor and parts, the cost is attributable to a "unitary transaction" as set out in IC § 6-2.5-1-1(a). The statute explains as follows:

> Except as provided in subsection (b), "unitary 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 Department's regulation, 45 IAC 2.2-1-1(a), states:

> For purposes of the state gross retail tax and use tax, such taxes shall apply and be computed in respect to each retail unitary transaction. A unitary transaction shall include all items of property and/or services for which a total combined charge or selling price is computed for payment irrespective of the fact that services which would not otherwise be taxable are included in the charge or selling price.

Because the maintenance agreements did not distinguish the price Taxpayer paid for labor and the price Taxpayer paid for parts, Taxpayer was correct in self-assessing use tax on the entire cost.

FINDING

Taxpayer's protest is respectfully denied.

IV. Pallets – Gross Retail Tax.

DISCUSSION

The Department's audit addressed the question of whether or not Taxpayer's purchase of shipping pallets was subject to sales/use tax.

The Taxpayer purchased pallets for use in their warehouse and for resale. Based on the findings from [state] sales tax audit, five percent of total purchases of pallets were established as used in the warehouse. The percentage was applied towards purchases of pallets, for the audit period.

Without saying so specifically, the audit apparently relies on 45 IAC 2.2-5-16 which states in part as follows:

> (a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers sold empty for refilling.
>
> (b) In general the gross proceeds from the sale of tangible personal property in a transaction of a retail merchant constituting selling at retail are taxable. This regulation [45 IAC 2.2] provided an exemption for wrapping materials and containers.
>
> (c) General rule. The receipt from a sale by a retail merchant of the following types of tangible personal property are exempt from state gross retail tax:
>
> (1) Nonreturnable containers and wrapping materials including steel strap and shipping pallets used by the purchaser as enclosures for selling tangible personal property. (Emphasis added).

The audit apparently determined that 95 percent of Taxpayer's pallets were being used as "nonreturnable containers" and were exempt pursuant to 45 IAC 2.2-5-16. The remaining five percent of the pallets were being "used" by Taxpayer within its Indiana distribution facility. Because these particular pallets were not used for shipping Taxpayer's products but were intended for internal use only, the pallets were subject to "use" tax pursuant to IC § 6-2.5-3-2(a).

Taxpayer states that, it "was not given a refund for use tax paid in error on purchases of refurbished pallets." However, it should be noted that – as explained in the "State of Facts," any overpayment will be offset against the remaining liability pursuant to IC § 6-8.1-8-1.5 and IC § 6-8.1-9-2.

The Department's audit division is requested to review the audit's original calculation along with the information supplied by the Taxpayer during the course of the protest. As agreed to originally both by the Taxpayer and by the original audit, Taxpayer should be given the appropriate "credit" for any amount of self-assessed use tax paid on 95 percent of the amount spent to purchase pallets.

FINDING

Taxpayer's protest is sustained subject to audit verification.

V. Hazardous Waste Disposal – Gross Retail Tax.

DISCUSSION

Taxpayer paid a company which specializes in the removal of hazardous waste products to dispose of certain items owned by Taxpayer. These "hazardous waste" included such items as lead acid batteries, lithium batteries, alcohol swabs, intravenous start kits, high pressure sodium bulbs, mercury vapor bulbs, and ordinary fluorescent bulbs. The invoice listed costs associated with the labor involved in the disposal project along with specific fees charged for disposing of these items. For example, Taxpayer was charged $380 to dispose of its sodium and its mercury vapor bulbs. Taxpayer was also charged $50 an hour for the services of a "chemist."

When Taxpayer paid the invoice, it self-assessed use tax. Taxpayer maintains that the self-assessment was in error.

As noted, Indiana imposes the complimentary use tax on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a).

Based on a review of the original invoice, Taxpayer is correct. Taxpayer has provided sufficient information to establish that it should not have self-assessed use tax on the cost it paid for this disposal project. Taxpayer was not purchasing light bulbs, batteries, or intravenous kits. Taxpayer was paying for the disposal of these and other items. As such, Taxpayer was paying for a service and the transaction was exempt.

FINDING

Taxpayer's protest is sustained.

VI. Purchase for Resale – Gross Retail Tax.

DISCUSSION

Taxpayer purchased 14,400 food additive tablets. At the time it paid for the tablets, it self-assessed use tax. Taxpayer maintains that it self-assessed the use tax in error because it purchased the tablets for resale.

Taxpayer apparently relies on the exemption set out in IC § 6-2.5-5-8(b) which states:

> Transactions involving tangible personal property other than a new motor vehicle are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business without changing the form of the property.

In applying any tax exemption, such as IC § 6-2.5-5-8(b), the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

In this particular instance, Taxpayer has provided a copy of the invoice from the original vendor and evidence from Taxpayer's own records that it self-assessed use tax on the purchase price. However, Taxpayer has not provided anything which would establish that the tablets were resold in the "ordinary course" of Taxpayer's business. Although the Department has no reason to doubt Taxpayer's best intentions in this matter, there is insufficient documentation upon which to determine that Taxpayer is entitled to the exemption.

FINDING

Taxpayer's protest is respectfully denied.

VII. Service Contracts – Gross Retail Tax.

DISCUSSION

Taxpayer hired vendors to perform service work at its Indiana facility. For example, Taxpayer hired a contractor to perform maintenance work on its heating and cooling system. At the time it paid these vendors, Taxpayer states that it self-assessed use tax on the contract price. Taxpayer maintains that it should not have self-assessed use tax on the entire contract price.

For a certain number of the invoices, the accompanying documentation differentiates between the cost of the labor and the cost of the materials. For example, on one particular repair contract, the labor cost is set out at $862.50 and the cost of the materials is $1,587.50.

In other instances, the invoice simply lists one price which includes both the labor and material expenses. For example, one particular invoice states that the "total value of the scope of the work" is $2,479. Presumably this price includes both labor and material costs because the agreement calls for the vendor to supply materials for the project. This second set of invoices falls within the category of "unitary transactions" as set out as follows:

IC § 6-2.5-1-1(a) states:

> Except as provided in subsection (b), "unitary 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 Department's regulation, 45 IAC 2.2-1-1(a), states:

> For purposes of the state gross retail tax and use tax, such taxes shall apply and be computed in respect to each retail unitary transaction. A unitary transaction shall include all items of property and/or services for which a total combined charge or selling price is computed for payment irrespective of the fact that services which would not otherwise be taxable are included in the charge or selling price.

Therefore, Taxpayer was correct when it self-assessed use tax on the price it paid vendors when the invoice included a "combined charge" for both the cost of labor and the cost of materials.

However, the Audit Division is requested to review the invoices which Taxpayer provided during the course of the protest and to provide a "credit" for the cost of specific labor charges set out and distinguished in those invoices.

FINDING

Taxpayer's protest is denied in part and sustained in part.

SUMMARY

Taxpayer was correct in arguing that it should not have self-assessed use tax on the $16,500 it paid "Vendor One." The Audit Division is requested to review the audit report and verify that Taxpayer is being given a credit for the purchase of pallets as described in the original audit report; Taxpayer was not required to self-assess use tax on the price it paid for the disposal of hazardous wastes; the audit division is requested to review invoices for service contracts in which the vendor distinguished between the price paid for labor and the price paid for materials; in all other respects, Taxpayer's protest is denied.

Posted: 06/29/2011 by Legislative Services Agency
An html version of this document.