DEPARTMENT OF STATE REVENUE

04-20110234.LOF

Letter of Findings: 04-20110234
Sales and Use Tax
For the Tax Years 2007-2009

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ISSUES

I. Sales and Use Tax –"Software Licenses"

Authority: IC § 6-2.5-1-27; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-13-2; IC § 6-8.1-5-1; Miles, Inc. v. Indiana Department of State Revenue, 659 N.E.2d 1158 (Ind. Tax Ct. 1995); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct.1991); Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); Supplemental Letter of Findings 04-20080413 (June 30, 2009); Letter of Findings 04-20080413 (March 25, 2009).

Taxpayer protests the imposition of use tax and/or the denial of refund of sales/use tax on its purchases of software licenses.

II. Sales and Use Tax –"Maintenance Agreements"

Authority: IC § 6-2.5-2-1; IC § 6-2.5-4-17; IC § 6-8.1-3-3; IC § 6-8.1-5-1; 45 IAC 2.2-4-2; Carroll County Rural Elec. Membership Coop. v. Dep't of State Revenue, 733 N.E.2d 44 (Ind. Tax Ct. 2000); Information Bulletin 2 (December 2006); Sales Tax Information Bulletin 2 (May 2002); Sales Tax Information Bulletin 2 (November 2000); Letter of Findings 04-20050438 (August 11, 2006).

Taxpayer protests the imposition of use tax and/or the denial of refund of sales/use tax on its purchase of "maintenance agreements."

STATEMENT OF FACTS

Taxpayer is a corporation operating in Indiana. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed additional use tax for the tax years 2007, 2008, and 2009. The Department found that Taxpayer had made a variety of purchases, including software licenses and software maintenance agreements, on which sales tax was not paid at the time of purchase nor was use tax remitted to the Department. During the audit, Taxpayer submitted a claim for a refund of $53,477 of sales tax paid during the 2007 through 2009 tax years on the ground that it had purchased software licenses and optional software maintenance agreements which were not subject to sales or use tax. On its claim for refund, Taxpayer stated that "only a portion of these [software] licenses were used in Indiana with the remaining portion being used by users located outside the state." In regard to the maintenance agreements, Taxpayer stated the agreements were not subject to sales tax because the agreements did not guarantee it would receive software updates or upgrades. Taxpayer's refund claim was incorporated into the audit and was denied in full. Taxpayer disagreed with the audit and protested the refund denial and the imposition of use tax on certain of the software licenses and software maintenance agreements. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as required.

I. Sales and Use Tax –"Software Licenses"

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

Taxpayer purchased computer software license agreements. In some instances, Taxpayer purchased one software license and in others Taxpayer purchased multiple licenses of the same computer program. During the audit, the Department found instances where Taxpayer had purchased software licenses without paying sales tax or accruing use tax at the time of purchase, and assessed used tax on the purchases. Taxpayer protests the extent that the use tax was assessed.

Taxpayer maintains that the software license agreements "were either partially or completely utilized outside Indiana." Taxpayer asserts that since a portion of the software licenses were used on computers located outside Indiana, it would be more reasonable to allocate a portion of the purchase fees to locations outside Indiana based upon the number of users in the state. Taxpayer states, "An accurate percentage of software license usage in Indiana can be obtained by comparing the number of global data center mailboxes assigned to Indiana locations as compared to the total number of global data center mailboxes worldwide which . . . using this methodology, approximately 69 [percent] of the licenses were used outside Indiana." In addition, Taxpayer asserts that its refund claim for the sales/use tax paid for certain software license purchases was incorrectly denied. Taxpayer maintains that when this usage allocation methodology is applied to these purchases, it is entitled to a refund of 69 percent of the sales/use tax that was paid.

IC § 6-2.5-3-2(a) provides, "An excise tax, known as the use tax, is imposed 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." An exemption from the use tax is granted for transactions where the gross retail tax ("sales tax") was paid at the time of purchase pursuant to IC § 6-2.5-3-4.

IC § 6-2.5-1-27 incorporates "prewritten computer software" such as that purchased by Taxpayer in the definition of tangible personal property as follows:

"Tangible personal property" means personal property that:

(1) can be seen, weighed, measured, felt, or touched; or

(2) is in any other manner perceptible to the senses.

The term includes electricity, water, gas, steam, and prewritten computer software.

Taxpayer explains that, "the intent of the law is to tax the value of only that portion of tangible personal property actually stored and used in Indiana."

In applying any tax exemption, 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). A statute which provides a tax exemption is strictly construed against the taxpayer. Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." Id. at 100-101.

Nevertheless, the Department is well aware of the countervailing rule that a "statute must not be construed so narrowly that it does not give effect to legislative intent because the intent of the legislature embodied in a statute constitutes the law." General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct.1991).

Taxpayer makes a more general argument that the software licenses–or an allocated portion of single software licenses–should be exempted based on the argument "that the courts have previously confirmed that the legislative intent is to tax only the portion of tangible personal property actually stored and used in Indiana." In particular, Taxpayer cites to Miles, Inc. v. Indiana Department of State Revenue, 659 N.E.2d 1158 (Ind. Tax Ct. 1995) as follows:

> If property is stored in Indiana for subsequent use outside Indiana, then the activities of storing, handling, and transporting the property cannot be taxed as "uses." To hold otherwise would subsume "storage" within "use" and nullify the exception for subsequent use outside Indiana. Id. at 1164.

IC § 6-2.5-3-2 states that "[a]n excise tax, known as the use tax, is imposed on the storage, use or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction . . . ." (Emphasis added). However, Indiana law provides a "temporary storage" exemption under IC § 6-2.5-3-1(b) which states:

> "Storage" means the keeping or retention of tangible personal property in Indiana for any purpose except the subsequent use of that property solely outside Indiana.

The issue is whether Taxpayer has established that it accepted delivery of software licenses but intended some of the licenses "for subsequent use of that property solely outside Indiana." Id.

During the protest, Taxpayer submitted a list of global mailbox users by country, which reflected there were 2,750 "everywhere" users and 860 users in Indiana. Taxpayer also submitted several invoices, most of which reflected that Taxpayer purchased one license, several reflected that Taxpayer purchased two licenses of the same computer program, and a few reflected that from three to a hundred licenses of the same computer program were purchased by Taxpayer. Taxpayer also presented an invoice for software maintenance agreements that reflected that 3,550 software maintenance agreements were purchased and an invoice reflected that 3,326 maintenance agreements were purchased. The Department would like to note that these two invoices would seemingly contradict Taxpayer's assertion that it only has 2750 computer users.

Taxpayer asks that an apportioned amount of sales/use tax be refunded and that the assessment be modified to assess tax on an apportioned amount. Taxpayer's calculation is apparently based upon the number of its "users" in Indiana compared to the number of "users" outside Indiana. Taxpayer explains that, "An accurate percentage of software license usage in Indiana can be obtained by comparing the number of global data center mailboxes assigned to Indiana locations as compared to the total number of global data center mailboxes worldwide which Taxpayer believes appropriately reflects the Indiana and non-Indiana usage of its various software licenses. Using this methodology, approximately 69 [percent] of the licenses were used outside of Indiana." However, other than the bare assertion that the licenses are used outside Indiana 69 percent of the time, Taxpayer has presented no independent documentary evidence which supplements its assertion or which justifies the notion that the sales tax on a single software license can be apportioned among multiple states or that any one of the two or hundred copies of the licenses that were purchased was used "solely outside Indiana." IC § 6-2.5-3-1(b).

Taxpayer points to Letter of Findings 04-20080413 (March 25, 2009), Supplemental Letter of Findings 04-20080413 (June 30, 2009), as supporting its position that it is entitled to a refund of sales tax on the multiple

license purchases, but the finding in those Letters of Findings was more narrow than Taxpayer suggests, as follows:

> However, while the information provided by Taxpayer was insufficient to demonstrate the full extent of Taxpayer's assertion, the information provided by Taxpayer did show that certain of the software/licenses purchases were not subject to Indiana use tax. Therefore, Taxpayer has provided sufficient documentation to demonstrate that the following purchases . . . are not subject to Indiana use tax . . . .

However, unlike the taxpayer in the Letters of Findings cited above, Taxpayer is unable to point with particularity to any of the licenses it purchased and to establish that these particular licenses are used outside Indiana.

Moreover, it appears Taxpayer invites the Department to treat Taxpayer as complying with "multiple points of use exemption" found at IC § 6-2.5-13-2 (repealed effective Jan. 1, 2008). IC § 6-2.5-13-2 (repealed effective Jan. 1, 2008), provided in relevant part, as follows:

> (a) Notwithstanding section 1 of this chapter, a business purchaser that
>
> (1) is not a holder of a direct pay permit; and
>
> (2) **knows at the time of purchase** of a digital good, computer software delivered electronically, or a service that the digital good, computer software delivered electronically, or service **will be concurrently available for use in more than one (1) jurisdiction**; **shall deliver to the seller in conjunction with its purchase a form disclosing** this fact ("multiple points of use" or "MPU" exemption form.)
>
> (b) Upon receipt of the MPU exemption form, the seller is relieved of all obligation to collect, pay, or remit the applicable tax and the **purchaser shall be obligated to collect, pay, or remit the applicable tax** on a direct pay basis.
>
> (c) **A purchaser delivering the MPU exemption form** may use any reasonable, but consistent and uniform method of apportionment that is supported by the purchaser's business records as they exist at the time of the consummation of the sale.
>
> . . .
>
> (**Emphasis added**).

Accordingly, purchasers, which present the "MPU exemption form" to the seller in conjunction with its purchase are granted the exemption, may use the apportionment method, and are obligated to pay the applicable tax on a direct pay basis.

However, during the course of the protest, Taxpayer failed to present documentation that it 1) held a direct pay permit, 2) presented "MPU exemption forms" to the sellers at the time of purchase of the software, 3) disclosed, at the time of purchase, its written intention to the seller to use the software at specific multiple locations, or 4) paid use tax, allocated or otherwise, to other jurisdictions based upon a written intention for use that was disclosed at the time of purchase. Since Taxpayer neither presented any "MPU exemption forms" to the sellers at the time of the purchases nor presented any evidence of a written intention for multiple use to the seller at the time of the purchases, Taxpayer cannot claim the exemption under IC § 6-2.5-13-2(c) and cannot apportion its use tax due at the time of purchase.

Therefore, given that exemptions are "strictly construed in favor of taxation and against the exemption," the Department is unable to depart from its initial conclusion that the purchases of the software licenses were correctly subject to Indiana sales/use tax. There is no indication that Taxpayer self-assessed use tax to other states based on its argument here that the licenses are being "used" in those other states. Taxpayer's argument, that use tax on a single software license can be apportioned between multiple states or that use tax on multiple software licenses should be apportioned between multiple states, lacks sufficient, specific, concrete substantiation.

FINDING

Taxpayer's protest to the imposition of use tax and/or denial of refund of sales/use tax for its purchases of software licenses is respectfully denied.

II. Sales and Use Tax –"Maintenance Agreements"

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

Taxpayer purchased various software "maintenance agreements." During the audit, the Department found instances where Taxpayer had purchased software "maintenance agreements" without paying sales tax at the time of purchase, and assessed used tax on the purchases. Also, during the audit, Taxpayer filed a refund claim stating that the software "maintenance agreements" were not subject to sales/use tax because the agreements did not guarantee it would receive software updates or upgrades. Taxpayer's refund claim was incorporated into the audit and was denied in full.

Taxpayer maintains that since the software "maintenance agreements" do not contain a provision which guaranteed that Taxpayer would automatically receive software updates and upgrades, the software "maintenance agreements" are not subject to Indiana sales/use tax.

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).

In support of its position that the transactions are not subject to sales/use tax, Taxpayer points to 45 IAC 2.2-4-2(a) which states:

> 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 . . . .

Taxpayer also points to Sales Tax Information Bulletin 2 (May 2002) as "outlin[ing] the position of the Legislature and the Department regarding optional maintenance agreements." An earlier version of Information Bulletin 2 stated as follows:

> 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) (Emphasis Added) (See also Sales Tax Information Bulletin 2 (November 2000) "Optional warranties and maintenance agreements that only contain the intangible right to have property supplied and there is no certainty that property will be supplied are not subject to sales tax.")

Taxpayer acknowledges that the Department subsequently amended the information bulletin revising its position. That revision states:

> Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are subject to sales tax if there is a reasonable expectation that tangible personal property will be provided. Any parts or tangible personal property supplied pursuant to this type of agreement are not subject to sales or use tax. Information Bulletin 2 (December 2006) (Emphasis Added).

Taxpayer relies on the May 2002 Information Bulletin, 25 Ind. Reg. 3595, as supporting its position that its maintenance agreements are exempt from sales tax because the maintenance agreements it purchased purportedly do not contain the right to obtain updates. Taxpayer challenges the position taken in the revised December 2006 Information Bulletin because the Department did not promulgate an accompanying regulation. Taxpayer cites to IC § 6-8.1-3-3 which requires as follows:

> (a) The department shall adopt, under IC 4-22-2, rules governing:
> (1) the administration, collection, and enforcement of the listed taxes;
> (2) **the interpretation of the statutes governing the listed taxes**;
> (3) the procedures relating to the listed taxes; and
> (4) the methods of valuing the items subject to the listed taxes.
> (b) **No change in the department's interpretation of a listed tax may take effect before the date the change is:**
> (1) adopted in a rule under this section; or
> (2) **published in the Indiana Register** under IC 4-22-7-7(a)(5), if IC 4-22-2 does not require the interpretation to be adopted as a rule; if the change would increase a taxpayer's liability for a listed tax.
> (**Emphasis Added**).

IC § 6-8.1-3-3 states that if the Department changes its "interpretation of a listed tax," it must either adopt a rule (regulation) under IC § 4-22-2 or give notice of that interpretation in the Indiana Register.

Taxpayer correctly points out that the Sales Tax Information Bulletin 2 (December 2006), 20100804 Ind. Reg. 045100497NRA, was not published in the Indiana Register until August 2010.

The previous 2002 version of the Information Bulletin did not require the vendor to collect sales tax on the sale of the extended warranties and maintenance agreements; however the vendor was required to self-assess use tax on any parts supplied pursuant to the terms of the warranty or agreement. The subsequent version of the Information Bulletin (2006) essentially reversed that requirement. The vendor was required to collect sales tax on the sale of the warranty but was not required to self-assess use tax on any parts supplied pursuant to the terms of the warranty. Presumably the subsequent version of Information Bulletin (2006) was a "change in the department's interpretation of a listed tax" as described in IC § 6-8.1-3-3 and triggered the Department's obligation to either adopt a regulation or publish notice of that "change" in the Indiana Register.

However, the Department must point out that prior to the issuance of the Information Bulletin 2 (December 2006), the Department issued Letter of Findings 04-20050438 (August 11, 2006), 20061101 Ind. Reg. 045060474NRA, in which 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.

In this particular taxpayer's situation, the department will apply this interpretation prospectively. (Published in the Indiana Register and available at http://www.in.gov/legislative/iac/20061101-IR-045060474NRA.xml.html) (**Emphasis added**).

As of the publication of Letter of Findings 04-20050438 (August 11, 2006), the Department fulfilled its obligation to give notice of its "change of interpretation" concerning the taxability of software maintenance agreements. As summarized in the Letter of Findings, "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."

In the case of the software maintenance agreements, the interpretations set out in the Sales Tax Information Bulletins are irrelevant. Instead, the interpretation set out in the August 2006 Letter of Findings governs the issue. The publication of that Letter of Findings met the requirements set out in IC § 6-8.1-3-3. See Carroll County Rural Elec. Membership Coop. v. Dep't of State Revenue, 733 N.E.2d 44, 49 n.5 (Ind. Tax Ct. 2000) ("The publication of the Letter of Findings is a prerequisite for the Department before it can change its position as to the interpretation of a tax, where the change would increase the taxpayer's liability.")

The Department is not required to discern whether the maintenance agreement vendors did or did not provide Taxpayer with computer software updates or whether the underlying agreement guaranteed that updates would be provided. The Department presumes that updates were provided pursuant to the agreements.

In addition, Taxpayer further maintains that software maintenance agreements were not subject to Indiana sales/use tax until the enactment of IC § 6-2.5-4-17 in July 1, 2010, which provides that " a person is a retail merchant making a retail transaction when the person enters into a computer software maintenance contract to provide future updates or upgrades to computer software."

However, the Department must disagree. As discussed previously, the Department has consistently found that software maintenance agreements were subject to sales and use tax for several years prior to the enactment of this legislation. Therefore, even when Taxpayer's argument–that this legislation changed the law–is presumed correct, a change from the current law would be changing the law from software maintenance agreements being subject to tax with a rebuttable presumption to software maintenance agreements always being subject to tax without the availability of a rebuttable presumption.

FINDING

Taxpayer's protest to the imposition of use tax and/or denial of refund of sales/use tax for its purchases of software "maintenance agreements" is respectfully denied.

SUMMARY

Taxpayer's protest, as discussed in Issue I and II, is respectfully denied.

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