DEPARTMENT OF STATE REVENUE

04-20110472.LOF

Letter of Findings: 04-20110472
Gross Retail Tax
For the Years 2008, 2009, and 2010

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 It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indian Register.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

ISSUE

I. Software Maintenance Agreement – Gross Retail Tax.

Authority: IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-8.1-3-3; IC § 6-8.1-3-3(b)(2); IC § 6-8.1-5-1(c): 45 IAC 2.2-4-2; Rural Carroll County Elec. Mem. Corp. v. Dep't of State Rev., 733 N.E.2d 44 (Ind. Tax Ct. 2000); Sales Tax 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 argues that it was not subject to sales/use tax on the purchase of a software maintenance agreement because the agreement did not provide for the provision of software updates.

STATEMENT OF FACTS

Taxpayer is an Indiana business which builds residential homes. Taxpayer hires subcontractors to perform the majority of the actual construction work.

The Indiana Department of Revenue ("Department") conducted an audit of Taxpayer's business records. The audit resulted in the assessment of additional sales/use tax. Taxpayer disagreed with the assessment and submitted a protest to that effect. An administrative hearing was conducted by telephone during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Software Maintenance Agreement – Gross Retail Tax.

DISCUSSION

The Department's audit found that Taxpayer paid for a software maintenance agreement on which it did not pay sales tax. The audit assessed sales/use tax on maintenance agreement transactions. Taxpayer disagrees on the ground that the agreement provided simply for the provision of services and that no "tangible personal property" was transferred pursuant to the agreement.

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).

However, in support of its position that it should not be require to pay the assessment, Taxpayer points to 45 IAC 2.2-4-2 which states:

> (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) the gross retail tax shall not apply to such transaction.

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."

The assessment of sales tax on Taxpayer's maintenance agreement included transactions during which two different versions of the relevant Information Bulletin were in effect. A prior, superseded version of Information Bulletin was in effect during 2008 and 2009 and a subsequent version was in effect during 2010.

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) (See also Sales Tax Information Bulletin 2 (November 2000), 24 Ind. Reg. 1192, "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.")

However, the Department subsequently amended the original Information Bulletin reversing its position on maintenance agreements. 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. Sales Tax Information Bulletin 2 (December 2006) (Emphasis added).

However, it should be noted that Sales Tax Information Bulletin 2 (December 2006) was not published in the Indiana Register until August 2010 and did not take effect in during 2006. 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 a 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 (December 2006) essentially reversed that position. 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. The subsequent version of Sales Tax 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 in addressing this issue, the Department points out that prior to the issuance of the Sales Tax Information Bulletin 2 (December 2006), the Department issued Letter of Findings 04-20050438 (August 11, 2006), 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.
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> 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.
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> 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**).
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> As of the publication of Letter of Findings 04-20050438 (August 11, 2006), the Department fulfilled its

obligation under IC § 6-8.1-3-3(b)(2) to give notice of its "change of interpretation" concerning the taxability of software maintenance agreements. As summarized in the August 2006 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 effect, the interpretation set out in the August 2006 Letter of Findings governs the issue raised by Taxpayer. The publication of that Letter of Findings met the requirements set out in IC § 6-8.1-3-3. See Rural Carroll County Elec. Mem. Corp. v. Dep't of State Rev., 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.")

However, the caveat in the Department's stance on this issue is whether or not the maintenance agreement is accompanied by the transfer of tangible personal property or – in the case of software maintenance agreements – updates to the software such as "services pack upgrades," "security patches," "reliability patches," and "upgrades." As explained in the August 2006 Letter of Findings, "A taxpayer could rebut this presumption (that updates were received) by demonstrating that no updates were actually received pursuant to a particular maintenance agreement or optional warranty." Alternatively, in the case of Sales Tax Information Bulletin 2, "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." Sales Tax Information Bulletin 2 (December 2006) (Emphasis added).

In Taxpayer's case, it is paying its vendor to update Taxpayer's computer software with "the latest Microsoft service packs and security patches" along with updates available from Veritas and Symantec. However, Taxpayer's vendor neither creates nor purchases the "service packs" and "security patches" but gleans those software updates from various publicly available sources and then applies them to Taxpayer's own software. The various Microsoft, Veritas, and Symantec updates are available on the Internet. As explained by Taxpayer's vendor, "[Taxpayer] hires our company to access those free updates and patches and install them on the server of [Taxpayer] as part of our services to make [Taxpayer's] servers perform appropriately." Taxpayer's vendor further explains that the "updates and patches are created and provided free of charge by Microsoft, Veritas, and Symantec and are generally available to the public."

Taxpayer has met its burden of proof of establishing that it does not pay its vendor for computer updates pursuant to the maintenance agreement at issue; Taxpayer's vendor performs a service pure and simple, and the related payments are not subject to sales or use tax.

FINDING

Taxpayer's protest is sustained.

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An html version of this document.