DEPARTMENT OF STATE REVENUE

04-20120426.LOF

Letter of Findings: 04-20120426
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 It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register.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. Temporary Storage Exemption – Gross Retail Tax.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-2.5-3-2(a); IC § 6-2.5-3-2(e); IC § 6-2.5-4-1(b), (c); IC § 6-8.1-5-1(c); Rhoade v. Indiana Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282 (Ind. Tax Ct. 1999); USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991).

Taxpayer argues that the Department of Revenue failed to provide Taxpayer a credit for sales tax paid on transactions for the purchase of tangible personal property when the property was subsequently sent to out-of-state locations.

II. Purchase for Resale – Gross Retail Tax.

Authority: IC § 6-2.5-2-1(b); IC § 6-2.5-8-8(a); Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988).

Taxpayer argues that its sale of software to a financial institution was exempt because the software was eventually resold to a purportedly exempt third-party.

III. Computer Services – Gross Retail Tax.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-1-27; IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-2.5-4-1; IC § 6-2.5-5-3(b); IC § 6-2.5-4-1(a); IC § 6-2.5-4-1(b); IC § 6-8.1-5-1(c); 45 IAC 2.2-5-8(b); Dictionary.com's 21st Century Lexicon http://dictionary.reference.com/browse/cloud+computing (last visited December 09, 2012).

Taxpayer maintains that it was not required to pay sales tax on the price Taxpayer paid to a vendor for what it characterizes as a service contract.

IV. Production Equipment – Gross Retail Tax.

Authority: IC § 6-2.5-5-3(b); IC § 6-8.1-5-1(c); 45 IAC 2.2-5-8; Indianapolis Fruit v. Dept. of State Revenue, 691 N.E.2d 1379 (Ind. Tax Ct. 1998); Mechanics Laundry & Supply v. Dept. of Revenue, 650 N.E.2d 1223 (Ind. Tax Ct. 1995); The American Heritage Science Dictionary, http://dictionary.reference.com/browse/server (last visited December 09, 2012).

Taxpayer argues that the tangible personal property it acquires to provide its clients computer services is exempt because the equipment is directly used in the direct production of tangible personal property.

STATEMENT OF FACTS

Taxpayer is a business which conducts business in Indiana and outside Indiana. Taxpayer supplies its customers with telephone, computer software, and information services. Taxpayer is registered for sales tax and withholding tax.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records. The audit resulted in the assessment of additional sales/use tax. Taxpayer protested on the ground that portions of the assessment were not justified by either fact or law. A hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

It should be noted that the Department's Audit Division reviewed documentation accompanying Taxpayer's protest but which was not made available at the time the original audit was conducted. The Audit Division agreed with Taxpayer that the documentation justified various adjustments to the original assessment. This Letter of Findings does not address issues which were reviewed and sustained prior to the hearing.

I. Temporary Storage Exemption – Gross Retail Tax.

DISCUSSION

Taxpayer argues it should not have been assessed sales/use tax on the purchase of certain tangible personal property because the property was temporarily stored in Indiana but was destined to be shipped to and used at an out-of-state location.

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 complementary 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. Indiana Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. Id. at 1047; USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466, 468–69 (Ind. Tax. Ct. 1993). The use tax ensures that, after such goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. Rhoade, 774 N.E.2d at 1048. A taxable retail transaction occurs when (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), (c); IC § 6-2.5-3-2(a).

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."

Tax exemption provisions – such as that here sought by Taxpayer – are strictly construed against exemption from the tax. Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999). 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 argues that it should be given credit for the amount of tax paid on five invoices. The invoices were issued by Business Furniture LLC and CDW Computer Center ("CDW"). Taxpayer explains that the "sole purpose of these purchases was to acquire tangible personal property that was to be solely used outside Indiana." In support of its contention that the five invoices were not subject to tax, Taxpayer cites to IC § 6-2.5-3-2(e) which states:

> (e) Notwithstanding any other provision of this section, the use tax is not imposed on the keeping, retaining, or exercising of any right or power over tangible personal property, if:
>
> (1) the property is delivered into Indiana by or for the purchaser of the property;
>
> (2) the property is delivered in Indiana for the sole purpose of being processed, printed, fabricated, or manufactured into, attached to, or incorporated into other tangible personal property; and
>
> (3) the property is subsequently transported out of state for use solely outside Indiana.

Taxpayer is correct in part. IC § 6-2.5-3-2(e) provides a "temporary storage" exemption from use tax when the tangible personal property is purchased from an out-of-state vendor, shipped to an Indiana location, but then subsequently "transported out of state for use solely outside Indiana."

In the case of its purchases from Business Furniture LLC, Taxpayer was assessed tax on purchases from this Indiana vendor which were either shipped or delivered to Taxpayer's Indiana facility but then later sent to out-of-state locations. Taxpayer predicates its protest on IC § 6-2.5-3-2(e) arguing that its temporary storage of personal property in Indiana did not give rise to a taxable exercise of ownership because Taxpayer's personal property – bought from Business Furniture LLC – was temporarily retained in Indiana for subsequent use outside of Indiana. As a result, Taxpayer argues, the items were exempt under IC § 6-2.5-3-2(e).

Taxpayer operates from an incorrect premise. The items Taxpayer purchased from Business Furniture LLC were subject to sales tax and sales tax was properly paid; however, the exemption Taxpayer seeks is inapplicable to items bought from an Indiana vendor, temporarily stored in Indiana, and then shipped to out-of-state locations. IC § 6-2.5-3-2(e) is inapplicable under Taxpayer's circumstances because there is no "temporary storage" exemption for sales tax.

Taxpayer purchased items from a company called CDW which is a company located in Illinois. Taxpayer explains that the items were not subject to tax because the "temporary storage exemption" operates to exempt the transactions and because the items were destined for a location in New Jersey. In support of that contention, Taxpayer points to its underlying company purchase order. The following notation is found at the bottom of the purchase order:

> PO Comments
> 1401 SV HUS
> 3755X & New Jersey DC
> [Individual Name]

Taxpayer maintains that the notation "3755X & New Jersey DC" is sufficient to establish that the items purchased from CDW were destined for a New Jersey location. The Department must disagree with Taxpayer's assertion because the notation is ambiguous. Other than the notation, Taxpayer has provided nothing which establishes that the tangible personal property was shipped to and used at one of Taxpayer's out-of-state

locations. Under Indiana law IC § 6-8.1-5-1(c) imposes upon a taxpayer the burden of establishing that the proposed assessment is wrong; the purchase order notation is insufficient to meet that burden.

FINDING

Taxpayer's protest is respectfully denied.

II. Purchase for Resale – Gross Retail Tax.

DISCUSSION

Taxpayer was assessed tax on the sale of software to a financial institution. Taxpayer maintains that the software was eventually resold to a third-party which presented the financial institution an exemption certificate. The exemption certificate asserts that the transaction between the financial institution and the third-party is exempt because the third-party will again resell the software back to the financial institution. Taxpayer believes that the transaction between itself and the financial institution should, therefore, be exempt.

Under IC § 6-2.5-8-8(a), "A person... who makes a purchase in a transaction which is exempt from the state gross retail tax and use taxes, may issue an exemption certificate to the seller instead of paying the tax." Once the purchaser provides the exemption certificate, the retail merchant is under no obligation to collect sales tax on the transaction. IC § 6-2.5-8-8(a) states that, "A seller accepting a proper exemption certificate under this section has no duty to collect or remit the state gross retail or use tax on that purchase."

Taxpayer specifically 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).

Taxpayer relies on the exemption certificate which purports to establish that third-party could purchase from financial institution the computer software for purposes of reselling the software back to financial institution. Taxpayer argues that this documentation is sufficient to establish that its sale of the software to financial institution is exempt because the financial institution intended to resell the software. Specifically, Taxpayer explains that its "sale was to [third-party] and not [financial institution] and [third-party] resold or leases the software to [financial institution].

The circular transaction – Taxpayer to financial institution to third-party to financial institution – notwithstanding, the original transaction at issue was between Taxpayer and financial institution. Was Taxpayer entitled to rely on the nature of the down-stream transactions to overcome its responsibility to collect sales tax from financial institution? IC § 6-2.5-2-1(b) imposes on retail merchants – in this case Taxpayer – the responsibility to collect sales tax as "an agent for the state." Without an exemption certificate from the entity which purchased the software, Taxpayer was obligated to collect and remit the tax.

FINDING

Taxpayer's protest is respectfully denied.

III. Computer Service – Gross Retail Tax.

DISCUSSION

The audit assessed sales tax on the price Taxpayer paid to a company here designated as "Vendor I". Taxpayer disagrees with the assessment on three different grounds. Taxpayer first argues a different entity will ultimately pay use tax on these same transactions. Taxpayer explains that it has "provided unequivocal proof" that any Indiana sales tax due on invoices issued by "Vendor I" from 2008 through 2010 will be paid to the Department through an audit of "Vendor I".

In addition, Taxpayer argues that the price it paid to "Vendor I" does not represent the purchase of tangible personal property. Taxpayer explains:

> [Taxpayer] has engaged [Vendor I] to provide Infrastructure as a Service. [Taxpayer] purchases processing storage, networks, and other fundamental computing resources from [Vendor I]. This is to enable [Taxpayer] to increase/decrease our IT needs as our company grows. [Taxpayer does] not receive any physical property from [Vendor I]. The master service agreement and the invoices are attached for our review. We do not receive any tangible personal property from [Vendor I]. We do not have any software licenses with [Vendor I]. Since we do not believe the invoices from [Vendor I] should be subject to sales/use tax.

Taxpayer makes a third argument related to the nature of the transaction between itself and "Vendor I" by which Taxpayer acquired pre-written software. Taxpayer argues that the price it paid allows it to access the pre-written software by means of "cloud computing" and that the pre-written software is therefore not subject to tax.

The first issue is whether Taxpayer can avoid the assessment on the ground that a different, unrelated entity may be subject to tax on the same transactions. As noted above, Indiana imposes an excise tax called "the state gross retail tax" on retail transactions made in Indiana. IC § 6-2.5-2-1(a). An entity such as Taxpayer which acquires property in a retail transaction is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). Indiana law does not contain a provision which enables a purchaser of tangible personal property to avoid tax on retail

transactions on the ground that the same tangible personal property might be taxed in either an upstream or downstream transaction. If Taxpayer engaged in a taxable transaction under the sales/use tax regime, Taxpayer is presumptively subject to the tax.

Taxpayer's secondary argument is that it engaged "Vendor I" to provide exempt services. As noted immediately above, IC § 6-2.5-2-1(a) imposes sales tax on retail transactions made in Indiana. IC § 6-2.5-1-2 defines a retail transaction as "a transaction of a retail merchant that constitutes selling at retail as described in IC § 6-2.5-4-1... or that is described in any other section of IC § 6-2.5-4." IC § 6-2.5-4-1(a) provides that "[a] person is a retail merchant making a retail transaction when he engages in selling at retail." IC § 6-2.5-4-1(b) further explains that a person sells at retail when he "(1) acquires tangible personal property for the purpose of resale; and (2) transfers that property to another person for consideration." As Taxpayer correctly concludes, if the subject transaction does not involve the acquisition of tangible personal property, the transaction is not subject to sales tax because there is no "retail transaction."

Taxpayer has provided copies of its "Master Service Agreement" with "Vendor I" and the invoices it received from "Vendor I". Taxpayer is correct in that its business relationship with "Vendor I" does require "Vendor I" to provide services to Taxpayer. The "Master Service Agreement" states that, "[Vendor I] agrees to provide the services as provided for in and subject of the Agreement...." However, the invoices establish that "Vendor I" is also selling Taxpayer tangible personal property such as cabinets, computer servers, and computer software.

The Department agrees with Taxpayer to the extent that "Vendor I" is selling Taxpayer exempt services. However, the Department is unable to agree with Taxpayer's assertion that "We do not receive any tangible personal property from [Vendor I]." A cursory review indicates that Taxpayer bought and paid for such items as a "processing node," "Microsoft server," "cabinet," "MS Basic DR," "External WAN switch port," "2x4 Core Processor," Colocation Cabinet," and "Microsoft Virtual Machine." These items represent taxable tangible personal property subject to the sales tax. As provided in IC § 6-2.5-1-27:

> "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.

However the "Vendor I" invoices also contain separately stated specific costs for items which are clearly "services" such as "storage," "24x7 support," and "Managed Services." The audit division is requested to review the "Vendor I" invoices and remove from the assessment those amounts clearly attributable to Taxpayer's acquisition of exempt services.

The third argument is that the pre-written software is accessed by means of "cloud computing" and that its purchase from "Vendor I" of the software is therefore exempt. Taxpayer explains that "cloud computing is a model for enabling ubiquitous, convenient, on-demand network access to a share pool of configurable resources.... that can be rapidly provisioned and released with minimal management effort or service provider interaction."

"Cloud computing" is defined as, "[A] type of computing based on sharing computing resources rather than having local servers or personal devices to handle applications." Dictionary.com's 21st Century Lexicon, http://dictionary.reference.com/browse/cloud+computing (last visited December 09, 2012). Taxpayer explains that "any tangible personal property... which is necessary to providing prewritten computer software via "cloud computing" should be excluded from Indiana sales tax." Taxpayer also believes that tangible personal property acquired by means of "cloud computing" services for its customers is exempt pursuant to IC § 6-2.5-5-3(b) which provides:

> Except as provided in subsection (c), transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

Taxpayer's third argument is somewhat unclear but – for purposes of this Letter of Findings – the Department will assume that Taxpayer does not believe the pre-written software is subject to sales tax because it does not acquire possession of the software. IC § 6-2.5-4-1 defines "retail transactions" as follows:

> (a) A person is a retail merchant making a retail transaction when he engages in selling at retail.
> (b) A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he:
> (1) acquires tangible personal property for the purpose of resale; and
> (2) transfers that property to another person for consideration.
> (c) For purposes of determining what constitutes selling at retail, it does not matter whether:
> (1) the property is transferred in the same form as when it was acquired;
> (2) the property is transferred alone or in conjunction with other property or services; or
> (3) the property is transferred conditionally or otherwise.

Taxpayer purchased "canned" computer software such as "Microsoft Virtual Machine" from Vendor I. If the computer program was conveyed on a physical medium such as a disk, then it would clearly constitute tangible personal property regardless of whether it could have been conveyed by other means. The fact that the software can be transferred by means of various media, i.e., from tape to disk, or tape to hard drive, or even that it can be

transferred over the Internet, does not take away from the fact that the software is recorded and stored in physical form upon a physical object. As the purchaser and user of canned computer software, Taxpayer is acquiring more than insubstantial knowledge or an intangible right; rather, Taxpayer is acquiring an electronic copy of a computer program that is stored on hardware, takes up space on a hard drive, and can be physically perceived by checking the computer's files for its absence or presence. The software remains on the computer and operates a program each time it is used. The Department is unable to agree with the Taxpayer's argument that the location of this software rather than its deemed acquisition and ultimate use determines the tax consequences of a transaction in which Taxpayer acquired an ownership interest in the canned software. Presumably, the software is accessed by means of the "Cloud computing" because it facilitates the functions performed by "Vendor I". However, that does not change the fact that Taxpayer bought and paid for canned software and that the mere invocation of "cloud computing" does not necessarily serve as a password or catch phrase which determines substantive tax consequences.

Taxpayer also suggests that the canned software and tangible personal property are exempt because these items are directly used in the direct production of tangible personal property pursuant to 45 IAC 2.2-5-8(b) which states in relevant part:

> The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property.

In the case of the canned software and tangible personal property acquired from "Vendor I", the argument is not well developed; Taxpayer has not provided information which establishes that Taxpayer uses the property for "direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property."

FINDING

Taxpayer is sustained in part and denied in part; to the extent that Taxpayer's purchased services from "Vendor I", the line-item charges are not subject to tax. To the extent that Taxpayer purchased tangible personal property – including pre-written computer software – Taxpayer's protest is respectfully denied.

IV. Production Equipment – Gross Retail Tax.

DISCUSSION

Taxpayer purchased computer software and hardware including servers. Taxpayer states that it uses these items to provide services to its customers. Taxpayer explains that, "The software is installed and then integrated into the server[s] in order to be accessed by customers through the cloud."

To that end, Taxpayer provided sample customer agreements along with sample customer invoices. The documentation establishes that Taxpayer provides a myriad of services to its customers. Taxpayer assists its customers in developing automated phone menus, developing efficient means by which to route incoming phone calls to the appropriate phone attendant or service provider, developing phone "trees," developing supervisory functions, and providing training to its customers employees.

Taxpayer argues that its purchases of "Computer Hardware, Software and related maintenance [equipment] used in providing [Software as a Service]" should be exempt under IC § 6-2.5-5-3(b). That provision states:

> Except as provided in subsection (c), transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

The Department's regulation restates the general principle but reinforces a distinctive caveat. 45 IAC 2.2-5-8 provides:

> (a) In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. The exemption provided in this regulation extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.
>
> (b) The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property.
>
> (c) The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property. (Emphasis added).

The regulation sets out the requirement that in order to claim the exemption, the machinery, tools, and equipment must be directly involved in the production of "tangible personal property." As the Tax Court explained in Mechanics Laundry & Supply v. Dept. of Revenue, 650 N.E.2d 1223, 1228 (Ind. Tax Ct. 1995), "Without the production of goods or, to use the language of the statute, 'other tangible personal property,' the equipment

exemption does not apply." (See also Indianapolis Fruit v. Dept. of State Revenue, 691 N.E.2d 1379, 1384 (Ind. Tax Ct. 1998), "[T]here is one iron-clad rule: without production there can be no exemption.").

Other than the assertion that Taxpayer produces "software offerings" for its customers, there is insufficient information to establish that Taxpayer's own software or servers are have "an immediate effect" on the software Taxpayer provides its customers.

Although agreeing with the basic premise that the computer software constitutes "tangible personal property" under the sales tax regime, the Department is unable to agree that either Taxpayer's software or servers have an active and direct effect on the software Taxpayer presumably provides its customers. (A "server" is simply a device "that manages centralized data storage or net communications resources." The American Heritage Science Dictionary, http://dictionary.reference.com/browse/server (last visited December 09, 2012)). Taxpayer provides its customers various services, and the exemption to which Taxpayer resorts requires the production of tangible personal property. Taxpayer has not met its burden under IC § 6-8.1-5-1(c) of establishing that the original assessment was wrong.

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

To the extent that Taxpayer's purchased services from "Vendor I", the line-item charges on Taxpayer's invoices are not subject to tax; in all other respects, Taxpayer's protest is denied.

Posted: 02/27/2013 by Legislative Services Agency
An html version of this document.