DEPARTMENT OF STATE REVENUE

04-20130309.LOF

Letter of Findings Number: 04-20130309
Use Tax
For Tax Years 2009-11

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.

ISSUE

I. Use Tax–Imposition.

Authority: IC § 6-2.5-1-1; IC § 6-2.5-1-11.5; IC § 6-2.5-1-27; IC § 6-2.5-13-1; IC § 6-2.5-1-24; IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-4-1; IC § 6-8.1-5-1; 45 IAC 2.2-3-4; 45 IAC 2.2-4-2; 45 IAC 2.2-4-27; Sales Tax Information Bulletin 8 (November 2011); Commissioner's Directive 41(October 2011).

Taxpayer protests a portion of the Department's assessment of use tax.

STATEMENT OF FACTS

Taxpayer is a corporation with operations in Indiana and several other states. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had underpaid sales tax for the tax years 2009, 2010, and 2011. The Department therefore issued proposed assessments for use tax and interest for those years. Taxpayer protested a portion of the use tax which was assessed. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Use Tax–Imposition.

DISCUSSION

Taxpayer protests a portion of the Department's proposed assessments of use tax for the tax years 2009-11. The Department based its proposed assessments on the basis that Taxpayer had purchases which were subject to sales tax but had not paid sales tax at the time of the transactions. Due to the large number of transactions, the Department used a random statistical sample and projection method to arrive at a taxable purchase rate for the years at issue. The Department reviewed all of the purchases in the statistical sample divided into seven strata by dollar amount and determined which purchases were taxable and which were non-taxable. Of those purchases determined to be taxable, the Department then reviewed the purchases to determine if sales tax had been paid at the time of purchase. The Department then calculated Taxpayer's total compliance rate and applied that to Taxpayer's total purchases for the tax years. Use tax was imposed on the difference between the compliance rate and the actual tax paid. The Department therefore issued proposed assessments for use tax. Taxpayer protests portions of the proposed assessments. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

Sales tax is imposed by IC § 6-2.5-2-1, which states:

> (a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.
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> (b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

Use tax is imposed under IC § 6-2.5-3-2(a), which states:

> 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.

45 IAC 2.2-3-4 further explains:

> Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

Therefore, when tangible personal property is used, stored, or consumed in Indiana, use tax is due unless sales tax was paid at the time of the transaction.

In this case, Taxpayer argues that the Department included purchases which were either exempt from sales and use tax or upon which Taxpayer had paid sales tax at the time of purchase as purchases upon which use tax was due. The first item under protest is found in strata seven-sort number fifty-five. As describe in the audit report and as described by Taxpayer, this purchase was for a "Tier 1 Service Initiation Fee" which Taxpayer paid to the vendor. The Department referred 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:
> (1) The serviceman is in an occupation which primarily furnishes and sells services, as distinguished from tangible personal property;
> (2) The tangible personal property purchased is used or consumed as a necessary incident to the service;
> (3) The price charged for tangible personal property is inconsequential (not to exceed 10[percent]) compared with the service charge; and
> (4) The serviceman pays gross retail tax or use tax upon the tangible personal property at the time of acquisition.
> (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.
> (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.
> (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.
> (Emphasis in original).

Taxpayer argues that the "Tier 1 Service Initiation Fee" was a separate charge for initial customization of the vendor's software prior to Taxpayer's utilization of that software. Taxpayer states that it did not purchase software or any other tangible personal property. Taxpayer refers to IC § 6-2.5-1-24, which provides:

> Subject to the following provisions, "prewritten computer software" means computer software, including prewritten upgrades, that is not designed and developed by the author or other creator to the specifications of a specific purchaser:
> (1) The combining of two (2) or more prewritten computer software programs or prewritten parts of the programs does not cause the combination to be other than prewritten computer software.
> (2) Prewritten computer software includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than the purchaser.
> (3) If a person modifies or enhances computer software of which the person is not the author or creator, the person is considered to be the author or creator only of the person's modifications or enhancements.
> (4) Prewritten computer software or a prewritten part of the software that is modified or enhanced to any degree, where the modification or enhancement is designed and developed to the specifications of a specific purchaser, remains prewritten computer software. However, where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such a modification or enhancement, the modification or enhancement is not prewritten computer software.
> (Emphasis added).

In this case, Taxpayer was able to provide sufficient documentation and analysis to establish that the "Tier 1 Service Initiation Fee" was for modifications or enhancements to the vendor's software and that there was a separately stated charge on an invoice which was given to the purchaser. Therefore, under IC § 6-2.5-4-1(4), such a modification or enhancement does not constitute prewritten software. Taxpayer has met the burden

imposed under IC § 6-8.1-5-1(c) regarding this transaction.

The next item under protest is a purchase found in strata seven-sort number 142. Taxpayer states that the amount listed by the Department as a taxable purchase of tangible personal property was actually a lease termination payment and as such was not subject to sales or use tax. The Department considered the payment to be a lease buyout and as such subject to sales and use tax. The relevant regulation is 45 IAC 2.2-4-27(d) which states in relevant part:

> The rental or leasing of tangible personal property, by whatever means effected and irrespective of the terms employed by the parties to describe such transaction, is taxable.
>
> (1) Amount of actual receipts. The amount of actual receipts means the gross receipts from the rental or leasing of tangible personal property without any deduction whatever for expenses or costs incidental to the conduct of the business. The gross receipts include any consideration received from the exercise of an option contained in the rental of lease agreement; royalties paid, or agreed to be paid, either on a lump sum or other production basis, for use of tangible personal property; and any receipts held by the lessor which may at the time of their receipt or some future time be applied by the lessor as rentals.
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> . . . .
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> (Emphasis added).

Taxpayer argues that the payment in question was a separately negotiated lease termination payment to its vendor. Taxpayer further states that the lease termination was not the exercise of an option in the lease itself. Rather, Taxpayer explains that the lease itself was non-cancellable and the payment it made was arranged between Taxpayer and the vendor in negotiations which were wholly separate from the lease agreement and its terms.

After review of the documents supplied in the protest process, the Department agrees that Taxpayer has established that the payment found in strata seven-sort number 142, was for a subject of separate negotiation and was not otherwise taxable. Taxpayer has met the burden imposed under IC § 6-8.1-5-1(c) regarding this payment.

The next group of transactions under protest involves four transactions with a single vendor. The transactions are found in strata two-sort number 123, strata four-sort number 119, strata 4-sort number 120, and strata six-sort number ninety-three. Taxpayer states that these four transactions were for access to information services and not for the purchase of tangible personal property. Taxpayer refers to Sales Tax Information Bulletin 8 (November 2011), 20111228 Ind. Reg. 045110765NRA, which states in relevant part:

> When statistical reports, graphs, diagrams, or any other information produced or compiled by a computer are transferred electronically to a customer, the transaction is not subject to sales tax. For more information on the application of Indiana sales tax to products transferred electronically, please refer to Section III below or Commissioner's Directive [number] 41, available online at www.in.gov/dor/3617.htm.

In turn, Commissioner's Directive 41 (October 2011), 20111026 Ind. Reg. 045110659NRA provides in relevant parts:

> Specified digital products, as defined by IC 6-2.5-1-26.5, IC 6-2.5-1-16.2, IC 6-2.5-1-16.3, and IC 6-2.5-1-16.4, currently includes only digital audio works (e.g., songs, spoken word recordings, and ringtones), digital audiovisual works (e.g., movies), and digital books. Pursuant to IC 6-2.5-4-16.4(b), Indiana imposes sales and use tax only on specified digital products that are transferred electronically along with the right of permanent use that is not conditioned on continued payment by the purchaser. Products transferred electronically are defined in IC 6-2.5-1-28.5 to mean products that are "obtained by a purchaser by means other than tangible storage media."
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> . . .
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> Based on the above authority, Indiana may no longer impose sales tax on a product transferred electronically by basing the product's taxability on inclusion of the product in the definition of tangible personal property. It is important to note that "computer software" and "telecommunication services" are not restricted by the phrase "product transferred electronically."
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> Effective upon the publication of this document, the Department will impose sales and use tax on products transferred electronically only if the products meet the definition of specified digital products, prewritten

computer software, or telecommunication services. Note: this document has no retroactive application. A claim for refund based on this document for a transaction subjected to tax prior to the publishing of this document will be denied.
(Emphasis added).

Therefore, as explained by Sales Tax Information Bulletin 8 (November 2011) and Commissioner's Directive 41 (October 2011), as of October 2011, the sale of statistical reports, graphs, diagrams, or any other information produced or compiled by a computer which were transferred electronically were no longer taxable in Indiana. However, as provided by Commissioner's Directive 41 (October 2011), this determination by the Department has no retroactive application. Therefore, any such purchases prior to October 2011 were still subject to tax.

The next set of transactions under protest concerns two purchases from the same vendor found at strata five-sort 131 and strata five-sort 133. Taxpayer protests that these two purchases were annual licensing fees for intellectual property supplied by the vendor. Taxpayer also states that the intellectual property was not software. After a review of the materials submitted in the course of the protest process, Taxpayer has established that the licensing fee did not include any transfer of tangible personal property. Therefore, Taxpayer has met the burden imposed under IC § 6-8.1-5-1(c).

The next transaction under protest is found at strata six-sort number twenty six. Taxpayer protests that this was a fee for allowing access to a vendor's online processing system. The Department considered this to be a computer maintenance/license/usage fee and, as such, subject to sales and use taxes. Taxpayer states that there was no transfer of software and that it only accessed the vendor's software via the internet. In reaching its determination that a taxable transfer had occurred, the Department referred to Sales Tax Information Bulletin 8 (November 2011) which provides in relevant part:

Prewritten computer software maintained on computer servers outside of Indiana also is subject to tax when accessed electronically via the Internet (i.e., "cloud computing"). The accessing of prewritten computer software by Indiana residents constitutes a transfer of the software because the customers gain constructive possession and the right to use, control, or direct the use of the software.

Example #3: An Indiana resident purchases a new computer that enables the purchaser to access prewritten computer programs maintained on a third party's computer servers located outside of Indiana. The purchaser never receives the software in a tangible medium. Instead, the purchaser's software, including any documents created with the software, is housed on the third party's server. The sales of these programs are subject to tax.

Therefore, the Department considered Taxpayer's electronic access of the vendor's prewritten software via the internet to be a taxable transfer of the software.

Taxpayer protests that Sales Tax Information Bulletin 8 (November 2011) is without authority in this case due to the fact that there is no tangible personal property delivered in this transaction. Taxpayer also refers to several court cases in support of its position that the Department is overstepping its authority in imposing sales and use taxes on such transactions. The Department refers to IC § 6-2.5-1-27, which provides:

"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.
(Emphasis added).

Next, IC § 6-2.5-13-1 states in relevant parts:

(a) As used in this section, the terms "receive" and "receipt" mean:
(1) taking possession of tangible personal property;
(2) making first use of services; or
(3) taking possession or making first use of digital goods; whichever comes first. The terms "receive" and "receipt" do not include possession by a shipping company on behalf of the purchaser.
(b) This section:
(1) applies regardless of the characterization of a product as tangible personal property, a digital good, or a service;
(2) applies only to the determination of a seller's obligation to pay or collect and remit a sales or use tax

with respect to the seller's retail sale of a product; and
(3) does not affect the obligation of a purchaser or lessee to remit tax on the use of the product to the taxing jurisdictions of that use.

. . .

(d)The retail sale, excluding lease or rental, of a product shall be sourced as follows:
(1) When the product is received by the purchaser at a business location of the seller, the sale is sourced to that business location.
(2) When the product is not received by the purchaser at a business location of the seller, the sale is sourced to the location where receipt by the purchaser (or the purchaser's donee, designated as such by the purchaser) occurs, including the location indicated by instructions for delivery to the purchaser (or donee), known to the seller.
(3) When subdivisions (1) and (2) do not apply, the sale is sourced to the location indicated by an address for the purchaser that is available from the business records of the seller that are maintained in the ordinary course of the seller's business when use of this address does not constitute bad faith.

. . . .

As previously explained, use tax is due when tangible personal property is stored, used, or consumed in Indiana, as provided by IC § 6-2.5-3-2(a). In this case, Taxpayer's employees used the vendor's prewritten computer software at Taxpayer's location in Indiana. A review of the "Software Licensing Agreement" provided in the course of the protest process and of the vendor's publicly available information on its web site establishes that Taxpayer was paying for the right to use the vendor's software and database together. Since IC § 6-2.5-1-27 and IC § 6-2.5-13-1 define prewritten computer software as tangible personal property and how such transactions are sourced, the Department is plainly acting within its bounds to impose sales and use taxes on such transactions. Therefore, use tax was properly imposed on this transaction.

The next transaction under protest is found at strata six-sort 117. Taxpayer protests that this transaction was for business-related classes taken online by Taxpayer's employees. As explained in the audit report, the Department considered these transactions to be for the purchase of services and tangible personal property in unitary transactions. Unitary transactions are defined by IC § 6-2.5-1-1(a), which provides:

> 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.

Taxpayer protests that the Department considered the transaction to be a "bundled transaction" as defined by IC § 6-2.5-1-11.5. However, as listed in the audit report, the Department's reason was, "software unitary, part not taxed." Therefore, the Department's reason for considering the transaction as subject to use tax was that it was a unitary transaction, not that it was a bundled transaction.

The Department again refers to Commissioner's Directive 41 (October 2011) provides in relevant part:

> Specified digital products, as defined by IC 6-2.5-1-26.5, IC 6-2.5-1-16.2, IC 6-2.5-1-16.3, and IC 6-2.5-1-16.4, currently includes only digital audio works (e.g., songs, spoken word recordings, and ringtones), digital audiovisual works (e.g., movies), and digital books. Pursuant to IC 6-2.5-4-16.4(b), Indiana imposes sales and use tax only on specified digital products that are transferred electronically along with the right of permanent use that is not conditioned on continued payment by the purchaser. Products transferred electronically are defined in IC 6-2.5-1-28.5 to mean products that are "obtained by a purchaser by means other than tangible storage media."
> (Emphasis added).

After review of the materials submitted during the protest process, Taxpayer has established that it did not receive the right of permanent use of the specified digital products in question. The "Master License Agreement" between Taxpayer and the vendor states that there was no transfer of property rights via the transaction and that any right to use the materials supplied by vendor would end the moment either party ended the licensing agreement. Therefore, as explained by Commissioner's Directive 41 (October 2011), such transactions are not subject to sales and use taxes.

Taxpayer protests the imposition of use tax on purchases from two more vendors. Specifically, Taxpayer protests the imposition of use tax on five transactions with one vendor from whom Taxpayer states that it purchased security services for mobile devices. Taxpayer also protests the imposition of use tax on two transactions with another vendor from whom Taxpayer states that it purchased hardware maintenance services. Taxpayer did not

provide any supporting documentation for its protest of the imposition of use tax on these seven transactions with these two vendors. Therefore, Taxpayer has not met the burden imposed by IC § 6-8.1-5-1(c).

In conclusion, Taxpayer has met the burden imposed by IC § 6-8.1-5-1(c) regarding transactions found at: strata seven-sort number fifty-five; strata seven-sort number 142; strata five-sort 131; strata five-sort 133. Also, Taxpayer has met the burden imposed by IC § 6-8.1-5-1(c) regarding the transactions found at strata two-sort number 123, strata four-sort number 119, strata 4-sort number 120, and strata six-sort number ninety-three, to the extent that those transactions occurred in or after October 2011. Taxpayer's protest is denied in regards to all other protested transactions. The Department will remove the transactions upon which Taxpayer has been sustained from its compliance percentage calculations and will recalculate that percentage. The recalculated percentage will be applied to Taxpayer's total purchases and new assessments for use tax due will be issued.

FINDING

Taxpayer's protest is sustained in part and denied in part, as provided above.

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