DEPARTMENT OF STATE REVENUE

04-20140506.LOF

Letter of Findings: 04-20140506
Gross Retail Tax
For the Years 2010, 2011, and 2012

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Medical Research Company was entitled to a use tax exemption on the purchase of software and software licenses for which it accepted delivery in Indiana but for which it was able to establish that specific licenses were used in locations outside Indiana. Medical Research Company was not required to pay sales or use tax on the purchase of computer software services.

ISSUE

I. Gross Retail Tax - Computer Software.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-1-24; IC § 6-2.5-1-27; IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-2.5-3-1(a); IC § 6-2.5-3-1(b); IC § 6-2.5-3-2; IC § 6-2.5-3-2(a); IC § 6-2.5-4-1(b); IC § 6-8.1-5-1(c); Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Conklin v. Town of Cambridge City, 58 Ind. 130 (1877); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Rhoade v. Indiana Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); Miles, Inc. v. Indiana Dep't of State Revenue, 659 N.E.2d 1158 (Ind. Tax Ct. 1995); USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); Indiana Dept. of State Rev. 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); Sales Tax Information Bulletin 8 (November 2011).

Taxpayer argues that it was not required to pay sales tax on the purchase of computer software and software licenses on the ground that the software and software licenses were used in locations outside Indiana.

II. Gross Retail Tax - Software Design Services.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-2-1(a); IC § 6-2.5-4-1(a); IC § 6-2.5-4-1(b); IC § 6-8.1-5-1(c); Sales Tax Information Bulletin 8 (November 2011).

Taxpayer maintains that it purchased software design services from one of its software vendors and that the purchase of these design services was not subject to sales or use tax.

STATEMENT OF FACTS

Taxpayer is an Indiana company in the business of providing medical research services. Taxpayer has business locations in Indiana, other states, and outside the country. The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns. The audit resulted in an assessment of additional sales/use tax. Taxpayer disagreed with a portion of the audit assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Gross Retail Tax - Computer Software.

DISCUSSION

The issue is whether Taxpayer met its burden of establishing that certain of its purchases of computer software and software licenses were not subject to Indiana sales or use tax on the ground that some of the software or software licenses were not used in this state.

As a threshold issue, it is the Taxpayer's responsibility to establish that the audit 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." Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

A. Audit Result.

The Department's audit found that Taxpayer purchased computer software without paying Indiana sales tax. The audit cited to Sales Tax Information Bulletin 8 (November 2011), 20111228 Ind. Reg. 045110765NRA, as authority for its decision that Taxpayer should have paid tax at the time it purchased the software. In part, the Bulletin provides:

> The sale or lease of computer hardware represents the transfer of tangible personal property and is a retail transaction subject to tax based on the total purchase price charged including, but not limited to, charges for instructional materials, installation charges, and internalized instruction codes that control the basic computer operations.

As further explained in the audit report, "The software was not specifically designed for [Taxpayer]" as custom software and that the software was "not directly used in direct production . . . ."

B. Taxpayer's Response.

Taxpayer argues that the audit erred in assessing tax on 100 percent of its software purchases because "in fact the software is used globally and not just in Indiana." According to Taxpayer, "It is our contention that only a portion of the software licenses . . . are used, stored, or consumed in Indiana."

1. Global Software Inc.

Taxpayer bought software from this company. According to Taxpayer the "software is primarily used by the financial and executive personnel of the company" and that the software "is housed within [each] user's machine."

Taxpayer states it purchased 40 software licenses from Global Software but only 16 of the licenses are used in Indiana. Based on comparing the number of software licenses it bought (40) and number it deployed in Indiana (16),Taxpayer concludes that "only 40[percent] of the software is used in Indiana and should be subject to tax."

2. Model Metrics.

Taxpayer purchased software from this vendor. The purchase agreement with Model Metrics grants Taxpayer 1,000 licenses. According to Taxpayer, it only uses 63 of the 1,000 licenses and only two of those licenses are used in Indiana. Based on comparing the number of licenses it bought (1,000) and the number it deployed in Indiana (2), Taxpayer concludes that "only 3[percent] of the software which is accessed and used within Indiana should [be] subject to tax."

3. Sparta Systems-Trackwise.

Taxpayer purchased 20 computer software licenses from this vendor. Taxpayer states that it uses the software in 13 states and that only two of the licenses are used in Indiana. Based on a comparison of the number of licenses it bought (20) and the number of licenses it uses in Indiana (2), Taxpayer concludes that "only 10[percent] of the software cost is used within Indiana and would be subject to tax."

4. Microsoft License Agreement One.

Taxpayer entered into two licensing agreements with Microsoft. In the first agreement, Taxpayer states that it

bought 76 licenses for "SQL server software." By comparing the number of licenses it bought (76) and the number of licenses it deployed in Indiana (4), Taxpayer concludes that only 5 percent of the licenses are used in Indiana and therefore only 5 percent of this first licensing agreement is subject to tax.

5. Microsoft License Agreement Two.

Taxpayer entered into a second licensing agreement with Microsoft. According to Taxpayer, this agreement allows Taxpayer to use "application software which is accessed through an online subscription." The software is used globally but only 84 percent of the software is accessed within the United States. Taxpayer bought 1,331 licenses but "only 135 licenses are accessed within Indiana." As a result, "only 10[percent] of the software should be subject to Indiana sales tax . . . ."

C. Hearing Analysis.

As mentioned at the outset, the issue is whether Taxpayer was required to pay use tax on the purchase of computer software licenses.

The sales and use tax assessment derives from the audit division's application of the state's sales and use tax provisions. 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 generally 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 1048; USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466, 469 (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. IC § 6-2.5-3-2(a). 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); IC § 6-2.5-3-2(a).

Indiana defines computer software as "tangible personal property" subject to Indiana sales and use tax. IC § 6-2.5-1-27 specifies that:

> "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).

"Prewritten computer software" is defined in IC § 6-2.5-1-24 which provides in part as follows:

> 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.

Taxpayer bought software licenses which are subject to Indiana sales and use tax. Taxpayer did not pay sales tax when it bought the licenses, and the Department's audit assessed use tax on those purchases.

However, Taxpayer maintains that some of the licenses are not subject to use tax because the licenses were only temporarily in this state. Pursuant to IC § 6-2.5-3-2, 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). As explained by the Tax Court in Miles, Inc. v. Indiana Dep't of State Revenue, 659 N.E.2d 1158, 1164 (Ind. Tax

Ct. 1995), Indiana law provides a "temporary storage" exception from the imposition of use tax in IC § 6-2.5-3-1(b) which defines "storage" as the "keeping or retention of tangible personal property in Indiana for any purpose except the subsequent use of that property solely outside Indiana." (Emphasis added).

In applying any tax exemption such as the temporary storage exemption, the overarching rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). A statute which provides a tax exemption, however 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 101 (citing Conklin v. Town of Cambridge City, 58 Ind. 130, 133 (1877)).

At the outset, the Department disagrees with the Taxpayer's basic application of the exemption to Taxpayer's own purchase of the licenses. For example, in the case of the purchase of 1,000 licenses from Model Metrics, Taxpayer states that it only deployed 63 of the 1,000 licenses and - of those 63 deployed licenses - only 2 of those licenses are used in Indiana. Taxpayer concludes that these 937 licenses are entitled to the exemption. Taxpayer would assume that the 937 surplus licenses are either used outside Indiana or are "nowhere" licenses outside the reach of Indiana's use tax. The Department does not agree. Taxpayer is an Indiana company which purchased and accepted the delivery of "tangible personal property" in this state but temporarily stored 61 of those licenses inside the state. Of the 1,000 licenses it bought, Taxpayer is potentially entitled to the exemption on 61 of those licenses not 998. The surplus 937 licenses were bought in this state and effectively "used" within Indiana.

Taxpayer provided information detailing the states the Global Software, Inc. software is used. The Department agrees that the information supplied is sufficient to establish that 23 of the licenses are "used" in Indiana and that 30 of the licenses are used outside the state. Therefore, 30 of the licenses are not subject to this state's use tax.

Taxpayer provided an extensive spreadsheet detailing the states the Model Metrics software is employed. The Department's Audit Division is requested to review the spreadsheet and exempt from tax those software licenses which are used in states outside Indiana. As described above, Taxpayer is not entitled to an exemption for those licenses which it bought, for which it accepted Indiana delivery, but for which there is no evidence that the licenses are "used" in another state.

Taxpayer provided information which is sufficient to establish that seven of the Sparta Systems-Trackwise software licenses are used in locations outside Indiana. Therefore, seven of the Sparta Systems-Trackwise licenses are not subject to this state's use tax.

Taxpayer provided an extensive spreadsheet detailing in which states the Microsoft License Agreement One software is employed. The Department's Audit Division is requested to review the spreadsheet and exempt from tax those software licenses which are used in states outside Indiana. As described above, Taxpayer is not entitled to an exemption for those licenses which it bought, for which it accepted Indiana delivery, but for which there is no evidence that the licenses are "used" in another state.

Taxpayer provided no information detailing in which states the Microsoft License Agreement Two software is deployed. Because Taxpayer has failed to meet its burden under IC § 6-8.1-5-1(c) of establishing that any portion of this assessment is "wrong," the Department is unable to adjust any portion of this particular assessment.

FINDING

Subject to review by the Department's Audit Division and as set out in Part I above, Taxpayer's protest is sustained in part and denied in part.

II. Gross Retail Tax - Software Design Services.

DISCUSSION

Taxpayer explains that it entered into an agreement with "Prophet One Solutions LLC." Taxpayer argues that it purchased services from Prophet One and not software. As Taxpayer explains:

> The agreement provides for consulting services in the development of software modifications and development. The work was performed by highly skilled individuals on an hourly basis.

Taxpayer concludes that the audit erred in assessing tax on a services contract.

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."

A transaction subject to the state's sales tax necessarily involves the transfer of "tangible personal property."

As noted in Part I above, IC § 6-8.1-5-1(c) places on Taxpayer the burden of establishing that audit's assessment of use tax was wrong.

Taxpayer provided a copy of the "Professional Services Agreement" it entered with Prophet One. The agreement provides that Prophet One provided Taxpayer with "consulting services as ordered from time to time in accordance with [the] Agreement." In turn, Taxpayer promised to pay Prophet One for "services." The Agreement provides that Taxpayer retains the "title, right, and interest" to the work product generated by Prophet One but the Agreement says nothing about the transfer, sale, or acquisition of "prewritten computer software."

Sales Tax Information Bulletin 8 (November 2011), 20111228 Ind. Reg. 045110765NRA, addresses the issue of custom designed software.

> As a general rule, transactions involving computer software are not subject to Indiana Sales or Use Tax provided the software is in the form of a custom program specifically designed for the purchaser.

The Department is prepared to agree that Taxpayer's agreement with Prophet One represented one in which Taxpayer paid this vendor for design services and that any software acquired pursuant to that Agreement was custom designed software for which Prophet One retained ownership. Under IC § 6-8.1-5-1(c), Taxpayer has met its burden of establishing that the October 1, 2007, Agreement represented a transaction for the purchase of custom designed software services not subject to Indiana's sales or use tax.

FINDING

Taxpayer's protest is sustained.

SUMMARY

To the extent that Taxpayer established that it accepted delivery of software and software licenses in Indiana but that the software or licenses were destined for use outside Indiana, Taxpayer's protest is sustained. Taxpayer was not subject to sales or use tax on the price it paid for software design services.

Posted: 08/26/2015 by Legislative Services Agency
An html version of this document.