DEPARTMENT OF STATE REVENUE

Revenue Ruling #2017-02ST
November 30, 2017

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ISSUES

Sales and Use Tax - Taxability of Transactions Involving Energy Savings

Authority: IC 6-2.5-1-11.5; IC 6-2.5-1-21; IC 6-2.5-2-1; IC 6-2.5-3-2; IC 6-2.5-4-10; IC 6-2.5-4-15; IC 6-2.5-5-8; 45 IAC 2.2-1-1; 45 IAC 2.2-4-2; 45 IAC 2.2-4-27; *Cowden & Sons Trucking, Inc. v. Indiana Dep't of State Revenue*, 575 N.E.2d 718 (Ind. T.C. 1991); *AWHR Am.'s Water Heater Rentals, LLC v. Indiana Dept. of State Revenue*, 941 N.E.2d 573 (Ind. T.C. 2010).

A company ("Company") is seeking a determination as to the following:

1. Whether Company is offering a non-taxable service that includes the provision of tangible personal property, or whether it is leasing tangible personal property, which would constitute a taxable retail transaction.
2. If it is determined that the transaction is a lease, whether Company can provide a resale certificate to the Vendor so that the Customer is not charged sales tax on both the original sale of equipment and again on the Service Contract payments.

STATEMENT OF FACTS

Company is a limited liability company based outside Indiana that provides energy-efficiency products. Company provides the following information regarding its business model and the structure of their transactions:

> [Company] purchases efficiency technology from a vendor. The new technology system is subsequently installed by one of [Company's] licensed "Service Providers." [Company] pays the Vendor for any hardware, software, and installation labor at the Customer location. [Company] also pays the Vendor for the state and local sales tax on the sale, which the Vendor then remits to the relevant Indiana jurisdiction.
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> [Company's] energy efficiency upgrades deliver energy savings to the Customer; however, [Company's] Service Contract does not guarantee energy savings. Instead, the contract guarantees function, or performance. A top accounting firm has provided guidance that the Company's Service Contract is distinct from a lease of tangible property, or a sale or transfer of equipment ownership for the following reasons:
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> 1. [Company] retains title, ownership, and control of the technology at all times. The Customer does not gain "possession" or ownership of the installed technology because the contract provides strict guidelines around how the equipment can and cannot be used. The Customer is in [*sic*] not allowed to alter the technology or provide any maintenance; only the licensed Service Provider is authorized to do so. The Customer does not gain title to the equipment over the contract term. [Company] may choose to offer the technology for purchase to the customer at the end of the term.
> 2. The "Service" is the achievement of performance criteria as measured by the Service Provider (transparently to the Customer). In the example of a Service Contract for a designed lighting solution, the Customer pays for lumen output and wattage delivery (rather than for ownership of equipment or installation and maintenance service).
> 3. The contract does not provide a list of the technology to be installed. Instead, the contract lists the output of the installed system in the building, as well as criteria for adequate performance. For example, in a Service Contract for lighting, the Customer does not see a list of fixtures to be installed. Instead, the Customer sees guaranteed lumen output and wattage draw for each area of the building. The Customer pays the Service Provider for the guarantee that the equipment will achieve and maintain an optimal level of performance, and thus the responsibility to restore the guaranteed level of performance if it should drop. If the Service Provider does not provide the Service to the level stated in the Service Contract, the Customer does not owe the next payment.

4. The technology is not permanently attached and is able to be removed. If the Customer defaults on his or her payment or stops remitting payment even though the technology is performing, [Company] has the right to reclaim the technology.
5. Utility fees are not included in the customer's monthly payment. The Customer pays the utility company for utility charges accrued from use of [Company's] equipment. Therefore, this monthly service payment should not be subject to sales tax as it applies to utility/electric charges.

Typical customers for this contract are commercial and MUSH (municipality, university, school, and hospital) entities.

DISCUSSION

Company requests that it be determined that its Customers are exempt from paying sales tax on the Service Contract monthly payments in accordance with 45 IAC 2.2-4-2. Alternatively, if the transactions are not found to be exempt, Company inquires as to whether it can provide an exemption certificate as a sale for resale to the Vendor so that the Customer is not charged sales tax on both the original sale of equipment and again on the Service Contract payments.

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).

Except for certain enumerated services, sales of services generally are not retail transactions and are not subject to sales or use tax. 45 IAC 2.2-4-2 clarifies the taxability of services as follows:

(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%) 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 [subsection (a)], the gross retail tax shall not apply to such transaction.

A unitary transaction is clarified in 45 IAC 2.2-1-1(a) as follows:

Unitary Transaction. For purposes of the state gross retail tax and use tax, such taxes shall apply and be computed in respect to each retail unitary transaction. A unitary transaction shall include all items of property and/or services for which a total combined charge or selling price is computed for payment irrespective of the fact that services which would not otherwise be taxable are included in the charge or selling price.

Pursuant to IC 6-2.5-4-10(a), "[a] person, other than a public utility, is a retail merchant making a retail transaction when he rents or leases tangible personal property to another person other than for subrent or sublease." IC 6-2.5-4-10(b) continues: "[a] person is a retail merchant making a retail transaction when the person sells any tangible personal property which has been rented or leased in the regular course of the person's rental or leasing

business." Indiana's regulations at 45 IAC 2.2-4-27(b) further states that:

> Every person engaged in the business of the rental or leasing of tangible personal property, other than a public utility, shall be deemed to be a retail merchant in respect thereto and such rental or leasing transaction shall constitute a retail transaction subject to the state gross retail tax on the amount of the actual receipts from such rental or leasing.

IC 6-2.5-1-21(a) defines leases, in pertinent part, to include "any transfer of possession or control of tangible personal property for a fixed or indeterminate term for consideration and may include future options to purchase or extend." Pursuant to the same statute, a lease does not include "a transfer of possession or control of property under an agreement that requires the transfer of title upon completion of required payments and payment of an option price that does not exceed the greater of one hundred dollars ($100) or one percent (1%) of the total required payments[.]"

45 IAC 2.2-4-27(c) provides:

> In general, the gross receipts from renting or leasing tangible personal property are subject to tax. The rental or leasing of tangible personal property constitutes a retail transaction, and every lessor is a retail merchant with respect to such transactions. The lessor must collect and remit the gross retail tax or use tax on the amount of actual receipts as agent for the state of Indiana. The tax is borne by the lessee, except when the lessee is otherwise exempt from taxation.

The term "actual receipts" is defined at 45 IAC 2.2-4-27(d):

> 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 [or] 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.

Pursuant to 45 IAC 2.2-4-27(d)(2), sales tax is due on the lease payments:

> Rental or lease period. For purposes of the imposition of the gross retail tax or use tax on rental or leasing transactions, each period for which a rental is payable shall be considered a complete transaction. In the case of a weekly rate, each week shall be considered a complete transaction. In the case of a continuing lease or contract, with or without a definite expiration date, where rental payments are to be made monthly or on some other periodic basis, each payment period shall be considered a completed transaction.

If the lease requires the transfer of title upon completion of required periodic payments and payment of an option price that is less than or equal to one hundred dollars ($100) or one percent (1%) of the total required payments, whichever is greater, then sales tax is due at the beginning of the lease. Otherwise, sales tax is due on each lease payment. IC 6-2.5-1-21(a)(2).

Turning to the present matter to determine whether Company's transaction is for a service or a lease of tangible personal property, Company presented five distinctions in order to differentiate the transaction from a lease or sale. The first was that Company retains title and ownership in the technology; however, that is often the case with leases of technology. Further, Company may sell the technology to their Customers at the end of the term, which can also occur in leases. Additionally, contrary to Company's suggestion that the Customers do not have possession of the technology, conflating possession with ownership, the Customers do have the technology in their possession, as they are installed at the Customers' locations.

In *AWHR Am.'s Water Heater Rentals, LLC v. Indiana Dept. of State Revenue*, 941 N.E.2d 573 (Ind. T.C. 2010), the Indiana Tax Court addressed a similar matter involving a taxpayer which asserted that its transactions were not leases because it did not transfer possession or control of water heaters it installed. The taxpayer claimed that they were "in the business of providing 'worry-free and economical hot water.'" They installed water heaters in customers' homes, and in exchange the customers "agreed to pay a monthly fee to AWHR." Id. at 574. The taxpayer provided the water heaters to its customers "at no charge," bore the expense installing the water heaters, and agreed to make any necessary repairs. It was also agreed that the taxpayer maintained ownership of

the water heaters. After an audit, "the Department [of Revenue] determined that AWHR should have collected sales tax from its Indiana customers during the years at issue. More specifically, the Department found that through its Plan, AWHR was leasing tangible personal property to its customers, thereby making the transactions subject to sales tax . . ." Id. The taxpayer maintained that it never transferred ownership and control of the water heaters, and therefore the transactions did not constitute leases.

The Court concluded that the transactions involving water heaters constituted lease transactions, reasoning:

> Given the facts of this case, AWHR's customers possessed and controlled the water heaters. Indeed, the water heaters were installed in the customers' homes and businesses. To the extent AWHR claims that it had access to the water heaters at all reasonable times, that access was ultimately controlled by the customer. The customers used the water heaters: by turning on the hot-water tap, they decided when they wanted hot water and how much of it they needed (and, therefore, they controlled the water heater's operation). The customers supplied the water and electricity necessary for the water heaters' operation. Accordingly, the Court finds that AWHR's customers had the requisite possession of, and control over, AWHR's water heaters to characterize the transactions as lease transactions. (Internal citations omitted).

Id. at 576. Like the taxpayer at issue in *AWHR*, Company may still own the equipment, but its Customers certainly have possession of the equipment when it is installed at the Customers' facilities, which supports a conclusion that the transactions constitute leases.

The second distinction is that Customers are charged for meeting performance criteria (in the example of a lighting solution, "lumen output and wattage delivery") instead of being charged a fee for the equipment, and may not be charged anything if the performance of the equipment is not to the level stated in the Service Contract. However, as 45 IAC 2.2-4-27(d)(1) states, "[t]he 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." (**Emphasis added**). Furthermore, the payment of a monthly fee is not determinative, as 45 IAC 2.2-4-27(d)(1) goes on to explain that any consideration received, even on a production basis, would be considered gross receipts:

> (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 [or] 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.

Turning to the third distinction that the contract does not provide a list of the technology to be installed, instead listing the output of the installed system in the building, this appears to be a standard service-level agreement ("SLA"), common in leases of technology. The technology involved is still tangible personal property, whether specific items are listed upfront or not.

The fourth distinction is that the technology is not permanently installed, but many things rented or leased by a business are not permanently attached to a business's property (e.g., copiers, printers, etc.). These types of equipment could also be reclaimed by the lessee under certain criteria, including nonpayment by the lessor, just like the technology at issue.

Finally, the fifth distinction is that utility fees are not included in the Customer's monthly payment, and therefore Company maintains that the monthly service payment should not be subject to sales tax as it applies to utility/electric charges. However, this is not convincing either. In situations where someone rents or leases a water softener or water heater, for instance, the lessee would be expected to pay their own utility fees, but the lease or rental payments would still be subject to sales tax.

It is also dubious that energy savings or energy solutions constitutes a true service, and Company has not done enough to establish that this is a service. Many types of equipment that are leased (computer hardware, water heaters, copiers, etc.) are guaranteed by the lessor to perform better and to provide savings, including energy savings. Applying the serviceperson test found at 45 IAC 2.2-4-2, Company does not satisfy all of the requirements of 45 IAC 2.2-4-2(a). Applying the first part of the test, it is not clear that Company is in the business of primarily selling and furnishing services, and not selling or leasing tangible personal property. 45 IAC 2.2-4-2(a)(1). Company would also fail the second part of the test, as it has not been proven that the technology is used for the purpose of providing the technology incident to a service. 45 IAC 2.2-4-2(a)(2).

Applying the test for bundled transactions, where the retail transaction includes both a service and tangible personal property, reveals a similar conclusion. IC 6-2.5-4-15 provides that "[a] person is a retail merchant making a retail transaction when the person sells tangible personal property as part of a bundled transaction." IC 6-2.5-1-11.5 defines "bundled transaction" in pertinent part for a retail transaction that includes a service and the provision of tangible personal property as follows:

> (b) "Bundled transaction" means a retail sale of two (2) or more products, except real property and services to real property, that are:
> (1) distinct;
> (2) identifiable; and
> (3) sold for one (1) nonitemized price.
> (c) The term does not include a retail sale in which the sales price of a product varies, or is negotiable, based on other products that the purchaser selects for inclusion in the transaction.
> (d) The term does not include a retail sale that:
> (1) is comprised of:
> (A) a service that is the true object of the transaction; and
> (B) tangible personal property that:
> (i) is essential to the use of the service; and
> (ii) is provided exclusively in connection with the service; . . .

The requirements for determining the "true object" of a transaction are not defined in statute. The Indiana Tax Court held in *Cowden & Sons Trucking, Inc. v. Indiana Dep't of State Revenue*, 575 N.E.2d 718 (Ind. T.C. 1991), that the determination of whether a sale was a retail transaction turned on whether the "true object" of the transaction was service or property. In *Cowden*, the taxpayer was a hauler who only on occasion sold stone at cost to his customers as a convenience, and therefore the Court concluded that the "true object" of the transaction was the provision of service and not the sale of stone.

The technology is essential to the use of the service and is provided exclusively in connection with the service. However, it would appear that the true object of the transaction is the technology. The technology is what Customers actually want, because of the potential for energy savings. To that point, Company "does not guarantee energy savings," but instead it "guarantees function," which further implies that Customers are paying for the technology. The energy savings, to the extent that they are achieved, are a benefit of the technology provided. Without the technology, there would be no benefit. Therefore, if there was a service involved, this would be considered a bundled transaction for a lease of tangible personal property, and thus sales tax is required to be collected from Customers.

For all of these reasons, Company's transactions are determined to be a lease of tangible personal property, which is considered a gross retail transaction per IC 6-2.5-4-10. Therefore, the technology monthly fee is subject to Indiana sales and use tax as a fee charged for leasing tangible personal property. However, to Taxpayer's second question, IC 6-2.5-5-8 provides that:

> [t]ransactions involving tangible personal property . . . 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."

Since Company purchases the technology for the purpose of leasing it, Company would be able to provide an Indiana General Sales Tax Exemption Certificate (Form ST-105) to the Vendor so that Company is not charged sales tax on the original sale, and Customers are only charged sales tax on the Service Contract payments.

RULING

The monthly fee charged by Company is subject to Indiana sales and use tax as a fee charged for leasing tangible personal property. However, Company may provide an Indiana General Sales Tax Exemption Certificate (Form ST-105) to the Vendor on the technology it purchases for purpose of leasing the technology to its Customers.

CAVEAT

This ruling is issued to the taxpayer requesting it on the assumption that the taxpayer's facts and circumstances as stated herein are correct. If the facts and circumstances given are not correct, or if they change, then the

taxpayer requesting this ruling may not rely on it. However, other taxpayers with substantially identical factual situations may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material respect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that subsequent to the publication of this ruling a change in statute, regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.

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