DEPARTMENT OF STATE REVENUE

04-201701000.LOF

Letter of Finding Number: 04-201701000
Sales/Use Tax
For Tax Years 2014-2016

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 This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. 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

Business failed to establish that software maintenance agreements were for exempt software; also, business did not prove that overhead cranes were used in an exempt manner.

ISSUE

I. Sales/Use Tax - Software Maintenance Agreements; Cranes

Authority: IC § 6-2.5-2-1; IC § 6-8.1-5-1; IC § 6-2.5-4-1; IC § 6-2.5-1-27; IC § 6-2.5-9-3; IC § 6-2.5-3-2; IC § 6-2.5-1-24; IC § 6-2.5-3-4; IC § 6-2.5-5-3; IC § 6-2.5-5-4; *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Rhoade v. Indiana Dept. of State Revenue*, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); *USAir, Inc. v. Indiana Dept. of State Revenue*, 623 N.E.2d 466 (Ind. Tax. Ct. 1993); *Indiana Dept. of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988); *Indiana Dept. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); 45 IAC 2.2-8-12; 45 IAC 2.2-5-3; 45 IAC 2.2-5-6; 45 IAC 2.2-5-8; 45 IAC 2.2-5-9; 45 IAC 2.2-5-10; 45 IAC 2.2-3-4; 45 IAC 2.2-3-14; Sales Tax Information Bulletin 8 (November 2011); Sales Tax Information Bulletin 2 (March 2013).

Taxpayer protests the Department's assessment of use tax for software maintenance agreements and repair costs for cranes.

STATEMENT OF FACTS

Taxpayer is a manufacturer and industrial processor of steel coils. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit for the years 2014 through 2016. As a result of the Department's audit, proposed assessments were issued. Taxpayer filed a protest with the Department. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Sales/Use Tax - Software Maintenance Agreements; Cranes

DISCUSSION

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." *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. 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.

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 "[r]etail transaction" is "a transaction of a retail merchant that constitutes selling at

retail as described in IC [§] 6-2.5-4-1 [or] . . . in any other section of IC 6-2.5-4." IC § 6-2.5-1-2(a). Selling at retail occurs when a person "(1) acquires tangible personal property for the purpose of resale; and (2) transfers that property to another person for consideration." IC § 6-2.5-4-1(b). IC § 6-2.5-1-27 further defines that "'[t]angible personal property' means personal property that . . . is in any other manner perceptible to the senses . . . including . . . prewritten computer software." "The retail merchant shall collect the tax as agent for the state." *Id*. The purchaser "who acquires property in a retail transaction is liable for the tax on the transaction and . . . shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction." IC § 6-2.5-2-1(b). If the retail merchant fails to collect the sales tax, the retail merchant "is personally liable for the payment of those taxes, plus any penalties and interest attributable to those taxes, to the state." IC § 6-2.5-9-3; 45 IAC 2.2-8-12.

On the other hand, the Indiana use tax is imposed on a person's storage, use, or consumption of tangible personal property, including prewritten computer software, 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); IC § 6-2.5-1-24; IC § 6-2.5-1-27. "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 Dept. 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. *Rhoade*, 774 N.E.2d at 1048; *USAir, Inc. v. Indiana Dept. 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. *Rhoade*, 774 N.E.2d at 1050. 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); *USAir, Inc.*, 623 N.E.2d at 468 - 69. 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) and (c); IC § 6-2.5-3-2(a).

Accordingly, as a general rule, all purchases of tangible personal property are taxable unless specifically exempted by statutes or regulations. 45 IAC 2.2-5-3(b); 45 IAC 2.2-5-6(a); 45 IAC 2.2-5-8(a); 45 IAC 2.2-5-9(a); 45 IAC 2.2-5-10(a). An exemption from the use tax is granted for transactions where the sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4 and 45 IAC 2.2-3-4. *See also* 45 IAC 2.2-3-14(1). There are various tax exemptions available outlined in IC 6-2.5-5 which are applicable to both sales tax and use tax. 45 IAC 2.2-3-14(2). A statute which provides a tax exemption, however, is strictly construed against the taxpayer. *Indiana Dept. 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 (internal citations omitted). In applying any tax exemption, 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). When a taxpayer challenges the taxability, the taxpayer is required to provide documentation explaining and supporting its challenge.

The Audit Report states that Taxpayer warehouses steel coils that "may belong to the taxpayer or may be owned by a third party." The Audit Report notes:

> Once the coils are brought into the facility they are uncoiled and fed into the slitter to remove the raw mill edges of the steel coils. The coils are cut to width, recoiled and banded. The processed coils are then sold to their customers.

Taxpayer also "receives revenue scrap sales, storage fees and packaging fees."

The Audit Report states that "[n]o adjustments" were being "proposed to the sales tax portion of the audit." Regarding use tax, the audit made adjustments. Those adjustments are what Taxpayer is protesting and are addressed below.

Computer Software Maintenance Agreements

At the outset, the Department notes that prewritten computer software is addressed by the Department in Sales Tax Information Bulletin 8 (November 2011), 20111228 Ind. Reg. 045110765NRA. In relevant part, that information bulletin states:

> The term **"prewritten computer software"** means computer software, including prewritten upgrades, which

is not designed and developed by the author or other creator to the specifications of a specific purchaser. Please note the following:

• The combining of two or more prewritten computer software programs or prewritten parts of the programs does not cause the combination to be something other than prewritten computer software.
• 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.
• 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.
• 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 considered a non-taxable service and not prewritten computer software.

See also Sales Tax Information Bulletin 8 (December 2016), which also similarly defines "prewritten computer software."

Turning to the protest, Taxpayer asserts that the computer maintenance agreements are not taxable. Taxpayer states that the "maintenance agreements . . . are for custom written software and any upgrades or maintenance is custom in nature." The Audit Report discusses the software maintenance agreement, stating:

Other items have been taxed in accordance with 45 IAC 2.2-5-8. This includes an "[] Service Agreement" purchase made from [Company G]. This "[service agreement]" is a complete Enterprise Resources Planning (ERP) software solution to manage daily operations for the steel and metals industry. The software performs inventory management, accounting administration, report writing and material tracking. The taxpayer has stated that the software does not currently control the machinery, but it has the capability to do so. As such the auditor has considered the software to be computer-aided design (CAD) software and subject to tax.

In other words, the Audit Report found the software at issue is not "used within the manufacturing process" and was thus taxable. The Audit Report also noted that the software is trademarked and sold by Company G "to potential customers."

Taxpayer counters that the software is not prewritten and that the "software is capable of operating manufacturing equipment and will eventually be used for that purpose. . . ." Regarding the latter argument, Taxpayer in effect concedes that the software is not used in an exempt manner for the time period of the audit (*e.g.*, Taxpayer states that the software will "eventually be used" to operate manufacturing equipment). Taxpayer's argument appears to be that if the software was customized then the software maintenance agreement would be exempt. Regarding the prewritten versus customized issue, Taxpayer states that the software system "was not usable in its 'out of the box' form," and that Taxpayer had to give "direction on all aspects of the custom developed system, including the idea to be Route Based." Taxpayer argues that the software was customized to Taxpayer's specific business needs. However, Taxpayer did not provide documentation or evidence of this alleged customization that might be germane (*e.g.*, if there were any communications between Taxpayer and Company G that would evidence customization of the software, etc.). Nor did Taxpayer provide an analysis of how Sales Tax Information Bulletin 2, which deals with "Original Manufacturer Warranties, Optional Maintenance Contracts, and Optional Warranty Contracts," applies to its protest. Lastly, the Department notes that subsequent to the hearing Taxpayer provided the Department with a copy of two amendments to the agreement between Taxpayer and Company G, but did not provide a copy of the actual agreement itself. The Department finds that Taxpayer has not provided documentation to support its contentions, thus the Department finds that Taxpayer has failed to meet its burden of proof pursuant to IC § 6-8.1-5-1(c).

Overhead Cranes

Taxpayer protests tax on "maintenance and repair costs for overhead cranes." The Audit Report states that there was a change in "the Indiana tax code, IC 6-2.5-5-4" that "provide[d] an exemption for property used in producing machinery, tools, or equipment to include material-handling equipment purchased for the purpose of transporting materials from storage to the production line." The auditor states that because of "this change in the law," that it "was determined that three cranes are exempt (two moving the steel rolls from storage to the production line and the crane used to load and unload the rolls at the slitter)." The auditor found that the "remaining four cranes" were taxable. Those four taxable cranes were "one [for] unloading the steel coils from the rail cars to storage and three

cranes used in postproduction activities . . . ." These crane purchases were "treated as 57[percent] taxable and 43[percent] exempt in 2016." For the years 2014 and 2015, the Audit Report found that "taxpayer paid use tax on the crane repairs listed at 100[percent]. Credit has been allowed on 14[percent] of the purchase amount as determined by the audit for years 2014 and 2015."

Taxpayer's protest letter states that auditor "determined that 86 percent of the repairs were subject to sales tax in 2014 and 2015." The protest also states that "[f]ifty seven percent of the repairs were deemed subject to sales tax in 2016." Taxpayer concludes that it "believes the repairs on cranes are not subject to sales tax or alternately the percent taxable in each year is significantly overstated." As to the specifics of Taxpayer's argument, Taxpayer states that the Department determined "that there should not be exemption of the three cranes in the receiving area because the material is unloaded from the trucks/railcars is put in a coil field, and not directly to the production line or staging area at the production line." Taxpayer asserts that "receiving cranes" are in fact "used to both unload materials and to deliver materials to the production line." Taxpayer cites to IC § 6-2.5-5-3, and then concludes:

> Even though these cranes move the steel coils from the trucks and railcars to a location until they are ready for production, they also move the material from that location to the production line, or are an integral part of the continues [*sic*] process with transfer cars to move materials to the production line. Therefore, they should qualify for a full exemption.

This paragraph does not clarify how the cranes at issue are actually used. On the one hand, Taxpayer states that though these cranes move the steel coils from the trucks and railcars to a location until they are ready for production (which would be pre-production storage), Taxpayer also asserts without providing proof, or even a percentage usage calculation, that the cranes are also used to move material to the production line. Taxpayer did provide a warehouse diagram–a bird's eye view drawing–of the facility. Taxpayer's protest letter attempts to describe how to 'read' the diagram as it relates to the cranes use. From the diagram, the cranes at issue appear to be used for and/or near the rail line, the "Master Coil Storage Area," and the "Scrap Boxes." And Taxpayer's description of the diagram states, "Cranes 5165 and 7855 . . . cannot move material directly to the production line as the cranes cannot cross bays." Taxpayer has not met its burden of proof. Taxpayer's protest is denied.

FINDING

Taxpayer's protest is denied.

May 30, 2018

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An html version of this document.