

INFORMATION BULLETIN #8

SALES TAX

NOVEMBER 2011

(Replaces Bulletin #8 dated May 2002)

DISCLAIMER: Information bulletins are intended to provide nontechnical assistance to the general public. Every attempt is made to provide information that is consistent with the appropriate statutes, rules, and court decisions. Any information that is inconsistent with the law, regulations, or court decisions is not binding on either the Department or the taxpayer. Therefore, information provided in this bulletin should serve only as a foundation for further investigation and study of the current law and procedures related to its subject matter.

SUBJECT: Application of Sales Tax to the Sale, Lease, or Use of Computer Hardware, Computer Software, and Digital Goods

REFERENCE: IC 6-2.5-1-13; IC 6-2.5-1-14.5; IC 6-2.5-1-16.2; IC 6-2.5-1-16.3; IC 6-2.5-1-16.4; IC 6-2.5-1-21; IC 6-2.5-1-24; IC 6-2.5-1-26.5; IC 6-2.5-1-27; IC 6-2.5-2-1; IC 6-2.5-2-2; IC 6-2.5-4-1; IC 6-2.5-5-3; IC 6-2.5-5-8

DIGEST: The substance and form of this bulletin have undergone substantial changes from the previous version.

I. Computer Hardware

a. Definitions

The term “**lease**” or “**rental**” means, in general, 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.

The term “**lease**” or “**rental**” does **not** include:

- (1) a transfer of possession or control of property under a security agreement or deferred payment plan that requires the transfer of title upon completion of the required payments;
- (2) 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 \$100 or 1% of the total required payments; or
- (3) providing tangible personal property along with an operator for a fixed or indeterminate period, if:
 - (A) the operator is necessary for the equipment to perform as designed; and
 - (B) the operator does more than maintain, inspect, or set up the tangible personal property.

The term “**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.

The term “**computer**” means an electronic device that accepts information in digital or similar form and manipulates it for a result based on a sequence of instructions.

The term “**computer hardware**” includes the machinery and equipment that constitute the physical computer assembly, including but not limited to such items as:

- Central processing units
- Keyboards
- Mice
- Video monitors
- Card or tape punchers
- Electronic message scramblers
- Data storage devices
- Processors
- Output units
- Flexowriters
- Card readers
- Paper tape input machines
- Verifiers
- Card converters
- Sorters
- Collators

- Printers
- Panels
- Terminals
- Modems

Note: The internalized instruction code that controls the basic (i.e., arithmetic and logic) operations of the computer and causes the computer to execute instructions contained in system programs is an integral part of the computer. It is not normally accessible or modifiable by the user. Such internal code systems are considered part of the computer's hardware.

The term “**terminal**” or “**online**” **arrangement** means any arrangement whereby the lessee or purchaser of a terminal unit or units is connected by telephone lines or other methods to a computer system in such a way that the input and output operations of the terminal unit and equipment are under direct control of the computer.

The term “**batch services arrangement**” means an arrangement whereby a consumer of computer services acquires access to a computer system in a manner that is not facilitated by a direct connection. Whatever data the consumer has for input is supplied to the operator of the computer for translation to a form acceptable by the computer. In such an arrangement, access to the computer can only be accomplished by intervention of the operator.

b. Application of Sales Tax to the Sale, Lease, or Use of Computer Hardware

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.

To the extent that computer hardware will be used directly in direct production of another product, its purchase is exempt from tax pursuant to the manufacturing exemption found at IC 6-2.5-5-3. To claim the exemption, the purchaser must show that the computer has an immediate effect on the article being produced as the result of being an essential and integral part of an integrated production process. With respect to computers, this is known as computer-assisted manufacturing (CAM). By contrast, computers used for research and development or preproduction functions, known as computer-assisted design (CAD), do not qualify for the manufacturing exemption. However, such computers may qualify for the research and development exemption. The exemption for research and development equipment applies only to equipment purchased for the purpose of research and development activities. Research and development activities include any activities devoted directly to experimental or laboratory research and development for new products, new uses of existing products, or improving or

testing existing products. For more information on the research and development exemption, please refer to Sales Tax Information Bulletin #75, available online at www.in.gov/dor/3650.htm.

The lease of a computer with exempt software programs where the bill is not segregated results in a transaction that is subject to tax on the entire charge.

Computer equipment and programs purchased or leased exempt from tax on the basis of a “resale” exemption are subject to use tax if they are put to a taxable use at any time subsequent to the exempt purchase. The subsequent sale of tangible personal property that has been leased or rented is subject to sales or use tax.

The sale or lease of computer time through the use of a terminal or as a result of a batch service arrangement is a nontaxable service and is not subject to tax if separately billed or charged. However, any charges for computer equipment (i.e., the terminal) remain subject to tax.

The sale of statistical reports, graphs, diagrams, or any other information produced or compiled by a computer and sold or reproduced for sale in substantially the same form as they are so produced is considered to be the sale of tangible personal property unless the information from which such reports was compiled was furnished by the same person to whom the finished report is sold. The charge for reports compiled by a computer exclusively from data furnished by the same person for whom the data is prepared is considered to be for a service and is not subject to sales or use tax unless it is part of a unitary transaction subject to sales or use tax.

Note: 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 #41, available online at www.in.gov/dor/3617.htm.

II. Computer Software

a. Definitions

The term “**computer software**” means a set of coded instructions designed to cause a computer or automatic data processing equipment to perform a task.

The software may be in the form of:

1. **System programs (except for the instruction codes, which are considered tangible personal property under Part I above)–**

- Programs that control the hardware itself and allow it to compile, assemble, and process application programs
2. **Application programs**—Programs that are created to perform business functions or control or monitor processes
 3. **Prewritten programs (canned)**—Programs that are either system programs or application programs and are not written specifically for the user
 4. **Custom programs**—Programs created specifically for the user

The term “**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. 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 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.

The term “**computer software maintenance contract**” means a contract that obligates a person to provide a customer with future patches, updates, upgrades, or repairs of computer software.

b. Application of Sales Tax to the Sale, Lease, or Use of Computer 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.

However, prewritten programs (i.e., canned software) not specifically designed for one purchaser, developed by the seller for sale or lease on the general market in the form of tangible personal property, and sold or leased in the form of tangible personal property are subject to tax irrespective of the fact that the program may require some modification for a purchaser’s particular computer.

Prewritten or canned computer programs are taxable because the intellectual property contained in the canned program is no different from the intellectual property in a videotape or a textbook.

Example #1: A software retailer that sells prepackaged programs for use with home television games or other personal computer equipment is considered to be a vendor of tangible personal property and is required to collect sales tax on the sales price of such property.

Example #2: A firm develops and sells prewritten application programs that are available to any of the firm's potential customers. The sales of these programs are subject to tax.

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.

III. Digital Goods

a. Definitions

The term "**transferred electronically**" refers to an item that is obtained by a purchaser by means other than tangible storage media.

The term "**specified digital products**" means electronically transferred (1) digital audio works; (2) digital audiovisual works; or (3) digital books.

The term "**digital audio works**" means works that result from the fixation of a series of musical, spoken, or other sounds, including ringtones.

The term "**ringtones**" means digitized sound files that: (1) are downloaded onto a device; and (2) may be used to alert the customer with respect to a communication.

The term "**digital audiovisual works**" means a series of related images that, when shown in succession, impart an impression of motion, together with accompanying sounds, if any.

The term “**digital books**” means works that are generally recognized in the ordinary and usual sense as books.

b. Application of Sales Tax to Products Transferred Electronically

Pursuant to IC 6-2.5-2-1(a) and IC 6-2.5-2-2(a), sales tax is imposed on retail transactions made in Indiana. Included in the definition of a retail transaction is the sale or lease of specified digital products. IC 6-2.5-4-16.4(b) provides:

A person is a retail merchant making a retail transaction when the person:

- (1) electronically transfers specified digital products to an end user; and
- (2) grants to the end user the right of permanent use of the specified digital products that is not conditioned upon continued payment by the purchaser.

The term “**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, ringtones, etc.), *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.

Pursuant to Section 333 (“Use of Specified Digital Products”—Effective Jan. 1, 2010) of the Streamlined Sales and Use Tax Agreement (SSUTA —Effective Sept. 20, 2009), of which Indiana is a signatory, “A member state shall not include any product transferred electronically in its definition of ‘tangible personal property.’” Pursuant to the same section of the SSUTA, “ancillary services,” “computer software,” and “telecommunication services” are excluded from the term “products transferred electronically.” However, IC 6-2.5-1-27.5(c)(8) explicitly excludes ancillary services from the definition of telecommunication services, which are taxable under IC 6-2.5-4-6 when such services are intrastate in nature. Accordingly, ancillary services are not subject to sales tax in Indiana.

Based on the above authority, Indiana may not 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.” For more information on the application of Indiana sales tax to computer hardware, software, or digital goods,

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please contact the Indiana Department of Revenue, Tax Policy Division, at 317-232-7282.

A handwritten signature in black ink that reads "John Eckart". The signature is written in a cursive style with a large, looping initial "J".

John Eckart
Commissioner