

STATE OF NORTH CAROLINA  
COUNTY OF WAKE

BEFORE THE  
SECRETARY OF REVENUE

IN THE MATTER OF:

The Proposed Assessment of Sales and Use )  
Tax for the period February 1, 1998 through )  
February 28, 2001, by the Secretary of )  
Revenue of North Carolina )  
 )  
vs. )  
 )  
[Taxpayer] )

**FINAL DECISION**  
Docket No. 2002-141

This matter was heard before the Assistant Secretary of Administrative Hearings, Eugene J. Cella, in the City of Raleigh, on June 27, 2002, upon application for hearing by the Taxpayer wherein it protested the proposed assessment of tax and interest for the period February 1, 1998 through February 28, 2001. The hearing was held by the Assistant Secretary pursuant to the provisions of G.S. 105-260.1. Representing the Sales and Use Tax Division were W. Timothy Holmes, Assistant Director, and Richard C. Stewart, Administration Officer. The Taxpayer was represented by [Taxpayer's Manager of Sales and Use Taxes].

The Taxpayer is a corporation engaged in business as a [manufacturer]. On September 21, 2001, an auditor with the Department completed an examination of the Taxpayer's records. The additional tax assessed resulted primarily from the Taxpayer's failure to accrue use tax on purchases of capital assets and expense items. Also, the Taxpayer has requested a credit for sales tax paid to a software vendor on fees the Taxpayer claims to be for an optional maintenance agreement.

Pursuant to G.S. 105-241.1, the Department mailed a Notice of Sales and Use Tax Assessment to the Taxpayer on October 11, 2001 assessing tax and interest in the amount of \$51,140.71. The Taxpayer objected to the assessment in a letter dated November 9, 2001 and timely requested a hearing before the Secretary of Revenue.

**ISSUES**

The issues to be decided in this matter are as follows:

1. Are the license fees paid for upgrades to canned computer software, which was previously purchased and tax paid thereon, subject to sales and use tax?
2. An alphanumeric code or key, which was transmitted over the Internet, activates dormant upgrades in software, which was previously purchased and taxed. The upgrades were not licensed at the time of the original transaction. Are the license fees

for the upgrades exempt from tax on the basis that there was no sale of tangible personal property since the alphanumeric codes were delivered over the Internet?

3. Are the fees the Taxpayer paid to a software vendor, referred to in the contract as usage and maintenance fees, fees paid for an optional maintenance contract and exempt from sales tax?

### **EVIDENCE**

The Sales and Use Tax Division presented the following items into evidence:

1. Copy of memorandum dated May 16, 2001 from the Secretary of Revenue to the Assistant Secretary of Administrative Hearings, designated Exhibit E-1.
2. Copy of the Field Auditor's report dated September 21, 2001, designated Exhibit E-2.
3. Copy of the Notice of Sales and Use Tax Assessment dated October 11, 2001, designated Exhibit E-3.
4. Copy of letter dated November 9, 2001 with attachments from the Taxpayer to the Sales and Use Tax Division, designated Exhibit E-4.
5. Copy of letter dated November 27, 2001 from the Sales and Use Tax Division to the Taxpayer, designated Exhibit E-5.
6. Copy of letter dated November 30, 2001 with attachments from the Taxpayer to the Sales and Use Tax Division, designated Exhibit E-6.
7. Copy of letter dated December 10, 2001 from the Sales and Use Tax Division to the Taxpayer, designated Exhibit E-7.
8. Copy of letter dated December 18, 2001 from the Taxpayer to the Sales and Use Tax Division, designated Exhibit E-8.
9. Copy of letter dated January 4, 2002 from the Taxpayer to the Sales and Use Tax Division, designated Exhibit E-9.
10. Copy of letter dated January 14, 2002 from the Sales and Use Tax Division to the Taxpayer, designated Exhibit E-10.
11. Copy of letter dated February 18, 2002 from the Assistant Secretary of Revenue to the Taxpayer, designated Exhibit E-11.
12. Copy of letter dated February 28, 2002 from the Taxpayer to the Assistant Secretary of Revenue, designated Exhibit E-12.
13. Copy of letter dated March 1, 2002 from the Assistant Secretary of Revenue to the Taxpayer, designated Exhibit E-13.
14. Copy of Sales and Use Tax Technical Bulletin 28-2, designated Exhibit E-14.

15. Copy of Sales and Use Tax Technical Bulletin 28-4, designated Exhibit E-15.
16. Copy of the Brief For Tax Hearing prepared by the Sales and Use Tax Division, designated as Exhibit E-16.
17. Copy of a brief for hearing prepared by the Taxpayer, designated Exhibit TP-1.

### **FINDINGS OF FACT**

Based on the foregoing evidence of record, the Assistant Secretary makes the following findings of fact:

1. The Taxpayer is a corporation engaged in business as a [manufacturer].
2. The Taxpayer purchased canned computer software packages from two vendors and paid the sales tax due on the transactions.
3. The software purchased by the Taxpayer contained latent upgrade capabilities, but the licensing for the additional capacity was not purchased by the Taxpayer at the time the original software was purchased. The Taxpayer subsequently purchased the licenses to use the latent upgrades from the software vendors.
4. Both of the software vendors transmitted alphanumeric codes via the Internet to the Taxpayer, which were used to unlock the upgrades in the software previously purchased.
5. The Taxpayer paid sales tax to a vendor for a "usage and maintenance fee" on computer software. Later, the Taxpayer decided that the maintenance agreement was optional and requested a credit for tax paid to the vendor against the tax assessed in the audit report.
6. The contract between the Taxpayer and the Taxpayer's software vendor combines the license to use the software with the maintenance of the software into a single fee.
7. The Department assessed use tax on the license fees paid by the Taxpayer to its software vendors for the use of the software upgrades.
8. The Notice of Sales and Use Tax Assessment was mailed to the Taxpayer on October 11, 2001.
9. The Taxpayer protested the assessment and timely requested a hearing before the Secretary of Revenue.

## **CONCLUSIONS OF LAW**

Based on the foregoing findings of fact, the Assistant Secretary makes the following conclusions of law:

1. The Taxpayer is a [manufacturer] and made purchases of tangible personal property for use during the audit period, which were subject to sales and use tax.
2. The alphanumeric codes delivered by software vendors to the Taxpayer over the Internet during the audit period are not software, but only keys used to access the dormant upgrades in existing software.
3. The license fees paid by the Taxpayer to use the software upgrades constitute the lease of tangible personal property and are subject to sales and use tax at the general State and applicable local rate of tax.
4. A proposed assessment is presumed to be correct. The burden is upon a taxpayer who takes exception to an assessment to overcome that presumption. The evidence present by the Taxpayer was not sufficient to overcome the presumption of correctness.
5. The Notice of Proposed Assessment for the period of February 1, 1998 through February 28, 2001 was issued pursuant to G.S. 105-241.1.

## **DECISION**

The Taxpayer purchased and paid sales tax in two separate transactions on prewritten computer software that contained latent upgrade capabilities. Sometime after the software was delivered to the Taxpayer, the Taxpayer contacted its software vendors and purchased the right to use the latent upgrades. In both cases, the vendors transmitted alphanumeric codes to the Taxpayer via the Internet, which the Taxpayer used to unlock the upgrade capabilities. The Taxpayer did not receive, in either case, additional tangible personal property when it purchased the license to use the upgrades.

The Taxpayer has taken the position that the license fees to use the upgrades are not subject to North Carolina sales tax since no additional tangible personal property was delivered. The State does not impose sales or use tax on sales of software transmitted from the vendor to the purchaser over the Internet. Since the alphanumeric codes, which unlocked the software upgrades, were transferred via the Internet, the Taxpayer contends that the licensing fees for the enhancements are exempt from tax.

The statutes define tangible personal property to include prewritten computer software delivered on a storage medium. The Taxpayer has not contended that the original purchases of the software were not taxable. The Taxpayer testified that the upgrades or enhancements were latent in the software at the time of the original purchase. It then follows that, with the original purchase of the software, the latent upgrades were also delivered on a storage medium.

The Department's position is that the alphanumeric code is not the software upgrade and the manner of delivery of the code is not relevant to the application of tax, and I agree. In the Taxpayer's brief and in testimony, the Taxpayer referred to the codes as "simply passwords to use the software." In this reference, the Taxpayer has clearly differentiated between the alphanumeric codes, "simply passwords," and the upgrades, "software." The Taxpayer testified that a computer technician types in the alphanumeric codes to activate the software; and that if the alphanumeric codes had been sent by U.S. Mail, they would agree that the upgrades would be taxable. To say that the upgrades constitute software delivered over the Internet only because the alphanumeric code used to unlock the software was sent electronically stretches the exemption far beyond its intent.

With regard to the Taxpayer's request for credit for tax paid to a software vendor in error, the terms of the contract do not support the Taxpayer's position. In order for a maintenance contract to be optional, the stated charge for the maintenance of the software and the license to use the software must be stated separately. On the third page of the contract between the Taxpayer and the software vendor, it states, in part, that:

"G1: A one-time fee 'OTF' inclusive of usage and maintenance for a one year period. Thereafter, continued usage of the Licensed Program and maintenance will be subject to an annual usage and maintenance fee 'UMF' equal to the then prevailing OTF for the Licensed Program multiplied by the then prevailing UMF rate for the Licensed Program."

The term "UMF" conjoins the usage of the software with the maintenance of the software into a single fee. The term is used throughout the contract and also appears on the invoice from the software vendor to the Taxpayer. The Taxpayer has provided no documentation to show that the license to use the software has been purchased separately from the fees paid for a maintenance agreement. I find, therefore, that the contract is not an optional maintenance contract and the Taxpayer is not entitled to any credit for tax paid for the usage and maintenance fees.

Wherefore the assessment is sustained in its entirety, and is declared to be final and immediately due and collectible.

This 9<sup>th</sup> day of August, 2002.

Signature \_\_\_\_\_

Eugene J. Cella  
Assistant Secretary of Administrative Hearings