

**Letter of Findings Number: 06-0262  
Sales and Use Tax  
For the Years 2003-2005**

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**ISSUES**

**I. Sales and Use Tax - Software and Computer Hardware**

**Authority:** IC § 6-8.1-5-1(b); IC § 6-2.5-2-1; IC § 6-2.5-3-2(a); IC § 6-2.5-3-2(c)(1); IC § 6-2.5-5-3(b); [45 IAC 2.2-5-8\(c\)](#); *Indiana Dep't of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983).

The Taxpayer protests the assessment of use tax on software and computer hardware.

**II. Sales and Use Tax - Printers and Printer Repair Parts**

**Authority:** IC § 6-2.5-5-3(b); [45 IAC 2.2-5-8\(c\)\(j\)](#).

The Taxpayer protests the assessment of use tax on printers and printer repair parts.

**III. Sales and Use Tax - Tags, Markers, Zebra Tape, Packing Lists, and Labels**

**Authority:** IC § 6-2.5-5-3(b); [45 IAC 2.2-5-8\(c\)\(d\)\(g\)\(j\)](#).

The Taxpayer protests the assessment of use tax on tags, markers, packing lists, zebra tapes, and labels.

**IV. Sales and Use Tax - Industrial Rugs, Mats, and Floor Dry**

**Authority:** IC § 6-2.5-5-3(b); [45 IAC 2.2-5-8\(c\)\(2\)\(F\)](#); [45 IAC 2.2-5-8\(j\)](#).

The Taxpayer protests the assessment of use tax on industrial rugs, mats, and floor dry.

**V. Sales and Use Tax - Software Maintenance Agreements**

**Authority:** IC § 6-2.5-5-3(b); IC § 6-2.5-3-2(c)(1).

The Taxpayer protests the assessment of use tax on software maintenance agreements.

**VI. Tax Administration- Ten Percent Negligence Penalty**

**Authority:** IC § 6-8.1-10-2.1; [45 IAC 15-11-2\(b\)](#).

The Taxpayer protests the imposition of the negligence penalty.

**STATEMENT OF FACTS**

The Taxpayer is a corporation which manufactures brake and axle components. The Indiana Department of Revenue, hereinafter referred to as the "Department," assessed Indiana use tax, interest, and penalty. The Taxpayer protested the assessments of use tax and penalty. The Department agreed that the items used in the production process, forklift rentals and repair parts, a capital asset purchased with sales tax paid, a capital asset purchase which was used in the production process, three software maintenance agreements, and propane were exempt. The Taxpayer protested the remainder of the assessments. A hearing was held. This Letter of Findings results.

**I. Sales and Use Tax - Software and Hardware**

**DISCUSSION**

Tax assessments are presumed to be accurate. IC § 6-8.1-5-1(b). The Taxpayer bears the burden of proving that any assessment is incorrect. *Id.* All exemptions are to be strictly construed against the Taxpayer. *Indiana Dep't of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983).

Indiana imposes a sales tax on the transfer of tangible personal property in a retail transaction. IC § 6-2.5-2-1. Indiana imposes a complementary excise tax, the use tax, on tangible personal property purchased in a retail transaction and stored, used, or consumed in Indiana. IC § 6-2.5-3-2(a). Payment of sales tax at the time of purchase exempts the tangible personal property from the use tax. IC § 6-2.5-3-2(c)(1). The manufacturing exemption from the sales and use tax is provided at IC § 6-2.5-5-3(b) as follows:

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. The manufacturing exemption is further described at [45 IAC 2.2-5-8\(c\)](#) as follows:

The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

The Taxpayer purchased a computer hardware and software package. They were used in both administration and production. Items used in a managerial or administrative function do not qualify for the manufacturing exemption. [45 IAC 2.2-5-8\(j\)](#). The Taxpayer and the Department agreed that the hardware and the software were used in a taxable administrative function about sixty percent of the time and in an exempt production function

about forty percent of the time. The Taxpayer paid sales tax at the time of purchasing the hardware and software package. In review, the Department credited the Taxpayer with the forty percent of the tax that was assessed. The Taxpayer protested this calculation. The Taxpayer argued that since the audit assessed tax on the exempt forty percent of the purchase price of the hardware and software package, the credit granted after review did not give the Taxpayer credit against the forty percent of the sales tax actually paid on the exempt portion of the purchase. Since the Taxpayer actually paid sales tax at the time of purchase, the Taxpayer is entitled to a credit for the amount of sales tax it originally paid on the exempt forty percent of the software and hardware.

**FINDING**

Subject to audit review, the taxpayer's protest is sustained.

**II. Sales and Use Tax - Printers and Printer Repair Parts**

**DISCUSSION**

The Taxpayer purchased thirty printers and repair parts for the printers. The Department considered the printers and repair parts to be used seventy percent in taxable administrative functions and thirty percent in exempt production functions. The Taxpayer contended that since twelve of the thirty printers were located in the manufacturing facility, forty percent of the printers and repair parts were used in an exempt manner pursuant to IC § 6-2.5-5-3(b).

Machinery is not exempt merely because it is used in a manufacturing area of a facility. To qualify for an exemption, the machinery must be integral and essential to the integrated production process. [45 IAC 2.2-5-8\(c\)](#). The Taxpayer stated that four of the computers in the manufacturing area were used to record the operator's time and the number of parts produced. This is not a manufacturing function because it does not directly affect the product. Rather, the recording of an operator's time and the number of parts produced is a management function. Machinery used for a managerial function is taxable. [45 IAC 2.2-5-8\(j\)](#). The Taxpayer did not sustain its burden of proving that the printers used for managerial purposes qualified for the manufacturing exemption.

**FINDING**

The Taxpayer's protest is respectfully denied.

**III. Sales and Use Tax - Tags, Markers, Zebra Tape, Packing Lists, and Labels**

**DISCUSSION**

The Department assessed use tax on tags, markers, zebra tape, packing lists, and labels. The tags were in a variety of colors. Each color represented a different step in the production process. The colored tags were attached to product in process so that forklift drivers could determine where to deliver the product for the next stage of the production process. The special markers were used to write instructions for the forklift drivers on the shrink wrap. The zebra ribbons were used in the printer to print information on labels which provide information to the customers. Employees used the packing lists to determine which items to pack. The Taxpayer argued that these items were exempt because they were used in the production process pursuant to IC § 6-2.5-5-3(b).

The "production process" is defined at [45 IAC 2.2-5-8\(d\)](#) as follows:

"Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

In the Taxpayer's situation, the direct production process ends with the wrapping of the product with shrink wrap. The special markers were used to write on the shrink wrap. Therefore, they were used after the termination of the production process. The zebra tape was used to print information on cards that were included with the product inside the shrink wrap. The printing of the cards was a separate process that was not part of the Taxpayer's integrated production process. The zebra tape and markers used to write on the shrink wrap did not qualify for the manufacturing exemption.

Colored tags were attached to product to indicate where the product should be moved within the production process. The colored tags instructed the forklift drivers where to move product in the production process. The packing lists also gave instructions to employees. Instructing employees is a managerial function. Tangible personal property used for managerial functions does not qualify for the manufacturing exemption. [45 IAC 2.2-5-8\(j\)](#).

The Taxpayer also protested the assessment of use tax on labels used to convey information to the customers. The information on the label included descriptions of the part, identification of the roll of steel, and the thickness and type of steel used in manufacturing the product. The label was then placed into an envelope that is put in the container before it is shrink wrapped. The labels did not affect the production of the product. Therefore, the labels were not necessary and integral to the production process. The labels did not qualify for the manufacturing exemption.

**FINDING**

The Taxpayer's protest is respectfully denied.

**IV. Sales and Use Tax - Industrial Rugs, Mats, and Floor Dry**

**DISCUSSION**

The Department assessed use tax on industrial rugs, mats, and "floor dry." Floor dry is an absorbent floor compound. The Taxpayer protested this assessment contending that the items were directly used in the direct

production process and therefore qualified for the manufacturing exemption. The Taxpayer says the floor dry, mats, and industrial rugs were essential to the safety of the employees and qualified for exemption pursuant to [45 IAC 2.2-5-8\(c\)\(2\)\(F\)](#) that exempts

Safety clothing or equipment that is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.

The floor dry, mats, and industrial rugs were not safety equipment. Rather, they were maintenance equipment that was used to keep the plant floor dry and clean. As cleaning agents, they were maintenance equipment and subject to the use tax pursuant to [45 IAC 2.2-5-8\(j\)](#).

**FINDING**

The Taxpayer's protest is respectfully denied.

**V. Sales and Use Tax - Software Maintenance Agreements**

**DISCUSSION**

The Department assessed use tax on certain software maintenance agreements. The Taxpayer originally protested the assessment alleging that the agreements were not subject to the use tax. In the initial review of the Taxpayer's protest, the Department determined that the sales tax had been paid on three of the software maintenance agreements. Pursuant to IC § 6-2.5-3-2(c)(1), use tax is not due on those agreements.

In its letter written February 16, 2007, the Taxpayer amended its protest as follows:

I propose to follow the agreement on the Hardware and Software issue – 40 [percent] is tax exempt as being an integral part of the manufacturing process.

There is no evidence that the protested maintenance agreement is related to the hardware and software that was determined to be forty percent exempt from the use tax. The Taxpayer did not sustain its burden of proving that the software maintenance agreement was used in an exempt manner pursuant to IC § 6-2.5-5-3(b).

**FINDING**

The Taxpayer's protest is respectfully denied.

**VI. Tax Administration- Ten Percent Negligence Penalty**

**DISCUSSION**

The Taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. [45 IAC 15-11-2\(b\)](#) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at [45 IAC 15-11-2\(c\)](#) as follows:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-1](#) if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The Taxpayer provided substantial documentation establishing that its failure to pay the assessed adjusted gross income tax was due to reasonable cause rather than negligence.

**FINDING**

The Taxpayer's protest to the negligence penalty is sustained.

*Posted: 06/20/2007 by Legislative Services Agency*

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