

**Letter of Findings Number: 06-0324
Sales and Use Tax
For the Tax Years 2003-2004**

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ISSUES

I. Sales and Use Tax – Software Program.

Authority: IC § 6-8.1-5-1(b); IC § 6-2.5-2-1(a); IC § 6-2.5-3-2(a); IC § 6-2.5-5-3(b); [45 IAC 2.2-5-8\(c\)](#); *Indiana Dep't of State Revenue v. Interstate Warehousing*, 783 N.E.2d 248 (Ind. 2003).

The Taxpayer protests the use tax assessment on a software program.

II. Sales and Use Tax – Steel Toed Shoes.

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

The Taxpayer protests the assessment of sales tax on sales of steel toed shoes.

III. Sales and Use Tax – Rack 18 Dividers/Frame.

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

The Taxpayer protests the assessment of use tax on Rack 18 Dividers/Frames.

IV. Tax Administration – Negligence Penalty.

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

The Taxpayer protests the imposition of the negligence penalty.

STATEMENT OF FACTS

The Taxpayer produces exhaust systems for automobiles. The Taxpayer filed a claim for refund of sales and use taxes paid during the tax period 2003-2004. The Indiana Department of Revenue (Department) evaluated the claim for refund by performing an audit for the years 2003-2004. The audit resulted in an additional assessment of use tax, interest, and penalty. The Taxpayer protested a portion of the assessments and the penalty. A hearing was held and this Letter of Findings results.

ISSUES

I. Sales and Use Tax – Computer Software.

DISCUSSION

During the tax period, the Taxpayer purchased software that was used to program and troubleshoot the equipment used in manufacturing, specifically the machinery that bends steel as the first step in the production process. The Department assessed use tax on the Taxpayer's use of these software programs. The Taxpayer protested this assessment contending that the software program qualified for a manufacturing exemption.

All tax assessments are presumed to be valid. IC § 6-8.1-5-1(b). The Taxpayer bears the burden of proving that any assessment is incorrect. *Id.* Exemption statutes are to be strictly construed against the Taxpayer. *Indiana Dep't of State Revenue v. Interstate Warehousing*, 783 N.E.2d 248 (Ind. 2003).

IC § 6-2.5-2-1(a) imposes sales tax on retail transactions made in Indiana. IC § 6-2.5-3-2(a) imposes a complementary use tax on the storage, use or consumption of tangible personal property in Indiana, if the property was acquired in a retail transaction as defined for sales tax purposes. IC § 6-2.5-5-3(b) provides for an exemption for tangible personal property directly used in the direct production of the Taxpayer's product for sale. This 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 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's computer software programmed and diagnosed problems with the machinery that was used to bend steel. The subject computer software did not actually operate the machinery. The steel bending machinery was an essential and integral part of the production process. It had an immediate effect on the production of the exhaust systems. The computer software program that programmed and troubleshoot the steel bending machinery, however, had an immediate effect on the steel bending equipment rather than the exhaust systems. The computer software program was used outside the production process. Since the computer programs on which the Department assessed use tax did not have an immediate effect on the bending of the steel, the computer programs did not qualify for the manufacturing exemption.

FINDING

The Taxpayer's protest is respectfully denied.

II. Sales and Use Tax – Steel Toed Shoes.

DISCUSSION

The Taxpayer protested the Department's assessment of use tax on steel toed shoes pursuant to IC § 6-2.5-2-1(a). The Taxpayer argued that these steel toed shoes qualified for the manufacturing exemption found at IC § 6-2.5-5-3(b).

Invoices indicate that the Taxpayer purchased the steel toed shoes and resold them to employees at cost. The Taxpayer used these steel toed shoes to provide a benefit for its employees – the opportunity to purchase steel toed shoes at a reduced price and at a convenient point of purchase. Using the steel toed shoes to provide a benefit in an effort to foster good will with the employees is a taxable use. The Department properly assessed use tax on the Taxpayer's use of the steel toed shoes to provide a benefit to its employees. The employees' use of the shoes does not affect the Taxpayer's use tax liability.

FINDING

The Taxpayer's protest is respectfully denied.

III. Sales and Use Tax – Rack 18 Dividers/Frame.**DISCUSSION**

The Taxpayer purchased several Rack 18 Dividers/Frames. Under authority of IC § 6-2.5-2-1(a), the Department assessed use tax on the racks. The Taxpayer protested the imposition, contending that the racks qualified for the manufacturing exemption pursuant to IC § 6-2.5-5-3(b). The Taxpayer argues that the racks are used to transport mufflers through the various steps of the production process. As such they are an essential and integral part of the production process and qualify for exemption.

[45 IAC 2.2-5-8\(f\)\(3\)](#) clarifies the manufacturing exemption as applying to transportation equipment as follows.

Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.

The racks have compartments and wheels. The Taxpayer places an incomplete muffler in each compartment on the rack. Each incomplete muffler is marked with a UPC code. The Taxpayer uses the racks to transport the incomplete mufflers to the various work stations. Workers scan the UPC code so the factory can track where the muffler is in the production process. At each work station, the workers perform a step in the production of the mufflers such as adding a part or painting. After each procedure, the muffler is placed back on the rack for transport to the next work station. When the muffler is fully assembled and painted, it is placed on a different storage unit. The racks are then used to transport more mufflers through the production process.

The Taxpayer sustained its burden of proving that the Rack 18 Dividers/Frames are used in an exempt manner.

FINDING

The Taxpayer's protest is sustained.

IV. 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. Indiana Regulation [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 to indicate that its failure to pay the assessed use tax was due to reasonable cause rather than negligence.

FINDING

The Taxpayer's protest to the imposition of the penalty is sustained.

Posted: 12/26/2007 by Legislative Services Agency

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