DEPARTMENT OF STATE REVENUE

04-20070410.LOF

Letter of Findings: 07-0410
Sales and Use Tax
For the Years 2004, 2005, 2006

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Use Tax – Imposition.

Authority: IC § 6-2.5-1-1; IC § 6-2.5-1-14; IC § 6-2.5-1-24; IC § 6-2.5-1-27; IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-8.1-5-1; 45 IAC 2.2-5-36; *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the imposition of use tax on some items.

II. Tax Administration – Imposition of Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

The Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer's principal business activity is that of a health care provider in Indiana. Taxpayer's medical services include primary and specialty care. Taxpayer also operates a full service optical shop, laser vision center, and a skin care center. Taxpayer is a for-profit domestic business trust which is owned and operated by its physicians.

The Department conducted a sales and use tax audit of Taxpayer for the years 2004, 2005, and 2006. Due to the large volume of purchase invoices to be reviewed for use tax, Taxpayer and the Department's auditor agreed to project the expense items purchased for the period covering the audit. Purchase invoices for 2006 were reviewed in their entirety. The results of this review were then projected to determine the additional taxable purchases of expense items for 2004 and 2005. Taxpayer and the Department agreed that credits found in 2006 might not fairly represent all the credits to which Taxpayer is entitled, therefore credits for 2004 and 2005 were also identified by Taxpayer and reviewed and verified by the Department. The credits for 2004, 2005, and 2006 were taken into account in the audit results.

The Department assessed Taxpayer additional sales and use tax pursuant to the audit. Taxpayer agreed with most of the assessment, but protested the assessment of use tax on certain "treatment cards" it used to provide laser eye surgery to its patients. The Department and Taxpayer refer to "key cards" and "Zyoptix treatment cards" ("treatment cards").

The treatment cards are similar in size to credit cards. The treatment cards, and all the other medical equipment and supplies relating to eye care, were acquired from the same supplier. The treatment cards were used in part to gain access to the supplier's laser equipment which was used by Taxpayer to perform laser eye surgery on its patients. Taxpayer stated that while the two treatment cards are used for different eye conditions, they function in the same manner. Taxpayer purchased six to seven batches of each card one to three months apart in 2006 for a total expenditure of $43,000. According to Taxpayer, the "key cards" cost $150 each and the "Zyoptix treatment cards" cost $250 each during the years of the protest. Taxpayer paid for the cards upon purchase. Generally one card is used per procedure. However, Taxpayer stated, in January 8, 2008, correspondence, that sometimes a patient requires the use of more than one card.

A hearing was held where Taxpayer was represented by its accountant. This Letter of Findings ensues. Additional facts will be presented as necessary.

I. Use Tax – Imposition.

DISCUSSION

On initial review, the Department found that Taxpayer had purchased the treatment cards without paying sales tax at the time of purchase, and assessed use tax on the purchase. The Department's audit report determined, under the regulation that addresses purchases made by licensed practitioners, that the cards were like a "licensing fee (rental fee) which allows the taxpayer to access and use the equipment (laser)... taxpayer is purchasing the privilege or right to use the refractive procedure to correct an individual's eyesight which is made possible through the use of the laser." 45 IAC 2.2-5-36.

Taxpayer argues that the cards are exempt from sales and use tax because the charge for them represents a royalty fee paid to the supplier.

All tax assessments are prima facie evidence that the Department's claim for the tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

IC § 6-2.5-2-1 provides:

(a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.

(b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

IC § 6-2.5-3-2(a) provides:

An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property 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.

Accordingly, Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq. An exemption from the use tax is granted for transactions where the gross retail tax ("sales tax") was paid at the time of purchase pursuant to IC § 6-2.5-3-4.

As a preliminary matter, this Letter of Findings addresses a document Taxpayer provided in support of its protest. Taxpayer obtained a letter from its supplier's tax director, dated July 10, 2007, that states the single use cards represent a "per procedure royalty fee for use of surgical laser equipment" and, therefore, as intangible property, are not subject to sales tax. In subsequent correspondence, dated January 8, 2008, Taxpayer stated its supplier plans to change the wording on the cards to "Zyoptix per procedure fee." Taxpayer stated that the requested change was being reviewed by its supplier's legal department. On a matter that involves a legal determination, such as this one, the supplier's letter only offers the bare statement that the cards are a per-procedure royalty fee. Furthermore, the fact that the supplier's legal department is reviewing the characterization implies that there is legal determination yet to be made. The Department takes the supplier's characterization of the transaction into consideration, but does not find its conclusory statement persuasive.

In order to determine whether or not the treatment cards are subject to Indiana sales and use tax, it is necessary to understand what the treatment cards actually do.

The Department's audit report states in relevant part:

The treatment/key cards are purchased from [supplier] and are inserted into the equipment which allows the taxpayer to operate a laser to perform a single refractive procedure (a separate card is necessary for each procedure). The taxpayer pays a flat charge for each card which allows the taxpayer access/use of the laser to perform a refractive procedure on their patient with the laser. The card only allows access to the equipment, and provides no medical treatment to the patient.

[The Department's statement in the last sentence quoted above is not correct as will be shown below.].

Taxpayer stated, in a July 25, 2007, communication, that "the treatment card... is put into the lasik machine to turn on the machine so the doctor can perform the lasik procedure." At hearing, Taxpayer's accountant repeated the assertion that the cards just turn on the machine to perform the procedure. When asked at hearing why a new card was needed for each procedure, Taxpayer's accountant stated that this is the way its supplier tracks each use. At the hearing, when the Department asked how the cards actually operate and whether the cards do more than unlock and record use of the laser equipment, Taxpayer's representative, the clinic's accountant and lacking in the technology know-how, was unable to answer the question. When asked the difference between the cards, Taxpayer stated that the cards were the same and that they simply dealt with different eye conditions. When asked for more clarification, Taxpayer relayed, in its subsequent January 8, 2008, correspondence with the Department the explanation by its ophthalmologist that the difference between the cards is the type of beam the machine emits when each card is used.

Therefore, while the Taxpayer's explanation of how the card operates lacks sufficient technical explanation, the explanation given by its ophthalmologist suggests that there are surgical uses for the cards, in addition to other theoretically possible uses.

The Department takes note of the following, quoted directly from the supplier's website (http://www.zyoptix.com/zyoptix_uk/treatment_card.html), that makes it absolutely clear that the treatment cards have an active surgical function:

The Zyoptix laser allows your surgeon to treat your corneas with much greater precision than with a standard treatment, shaping laser treatment for your eyes only. This is because, as well as a standard 2 millimeter diameter beam, the Zyoptix laser also has a finer 1 millimeter for fine-tuning and for treating aberrations caused by scattered light.

Both laser beams are shaped by your personal Zyoptix Treatment Card, controlling the laser beam throughout every stage of your treatment. Only one card is used per treatment to make absolutely sure that the beam it produces is of the highest quality.

(*Emphasis added*).

The Centre for Sight in the U.K., describes on its website (www.centreforsight.com) how the treatment cards work in conjunction with other highly specialized diagnostic equipment and laser equipment to provide a higher level of individualized care to its patients:

The Zyoptix laser allows your surgeon to treat your corneas with much greater precision than with a standard treatment, shaping laser treatment for your eyes only. This is because, as well as a standard 2mm diameter

beam, the Zyoptix Z100 laser also has a finer 1mm beam for fine-tuning and for treating the aberrations caused by scattered light. *Both laser beams are shaped by your personal Zyoptix Treatment Card, controlling the laser beam throughout every stage of your treatment. The treatment card changes the size and shape of the laser beam*...

(*Emphasis added*).

Based on the above, there is no doubt that Taxpayer's treatment cards are an integral part of the surgical procedure. The treatment cards are considered surgical software in that they contain "a set of coded instructions designed to cause a computer or data processing equipment to perform a task." IC § 6-2.5-1-14. Furthermore, the treatment cards are considered pre-written computer software because they are not designed and developed by their author to the specifications of a specific user. IC § 6-2.5-1-24. Prewritten computer software is tangible personal property under IC § 6-2.5-1-27.

45 IAC 2.2-5-36 addresses purchases made by licensed practitioners and states:

(a) The gross retail tax shall apply to the following purchase transactions made by licensed practitioners:

(1) All office furniture, equipment and supplies.

(2) Drugs of a type not requiring a prescription, when not purchased for resale.

(3) Surgical instruments, equipment and supplies.

(4) Bandages, splints, and all other medical supplies consumed in professional use.

(5) X-Ray, diathermy, diagnostic equipment, or any other apparatus used in the practice of surgery or medicine.

(b) The purchase of items for resale by the physician or surgeon. In order to resell items the practitioner must be licensed as a retail merchant, and must quote the selling price of any items separately from the charge for professional service.

Therefore, under 45 IAC 2.2-5-36(3), the treatment cards are, at least in substantial part, tangible personal property transferred in a retail transaction.

In order to further understand the use of the treatment cards, the Department looked to the lease agreement, dated June 21, 2000, between Taxpayer and its supplier, provided at the request of the Department.

Article 1 of the lease agreement presents certain definitions for terms used in the agreement. Among those definitions are two that are relevant to this protest.

Section 1.12 defines "Refractive Per-Procedure Fee" to mean "an obligation of Customer to pay One Hundred ($100.00) for each Refractive Procedure performed using the Laser." Section 1.19 defines "Treatment Card(s)" to mean "an individual card which is necessary for the Laser to perform a single Refractive Procedure."

Article 2 of the agreement presents the duties of the customer, in this instance Taxpayer. Section 2.2 states Taxpayer's duties that relate to the "Treatment Card:" "[supplier] shall sell, and Customer shall purchase, each Treatment Card for One Hundred and Ten ($110.00), which shall include the Refractive Per-Procedure Fee payable by Customer under Section 2.3 hereof." Section 2.3 states duties that relate to the "Refractive Per-Procedure Fee," and requires Taxpayer "to pay [supplier] a Refractive Per-Procedure Fee for each Refractive Procedure performed using the Laser."

Nowhere in the definitions or statement of duties is there a reference to royalty fees, intellectual property, or any terms that suggest those concepts. Furthermore, the "Refractive Per-Procedure Fee," presumably the "royalty fee" Taxpayer references, could be deemed a license fee as the Department's audit determined. The lease agreement specifically references, in section 2.2, the grant to Taxpayer of a license to use supplier's software and "all materials furnished or produced in connection with the [s]oftware." So, the "Refractive Per-Procedure Fee" could well be deemed a license fee subsumed into the cost of the treatment card and subject to sales tax. 45 IAC 2.2-5-36.

What is clear is that the definitions section of the agreement illustrates that the treatment cards and fees are two separate things. What is also clear is that the terms setting out Taxpayer's duties towards its supplier, suggest that at least some substantial portion of the price Taxpayer pays for the treatment cards is not related to a fee, theoretically either a royalty or license fee, connected with the mere use of the refractive laser technology per procedure. Per the lease agreement, in the year 2000, the treatment cards cost Taxpayer $110 each, with $100 of that amount – ninety percent - representing the "Refractive Per-Procedure Fee," and ten-percent representing something else.

The supplier's website clearly establishes that the treatment cards have a surgical function. Furthermore, the Department does not accept the proposition that any portion of the cost of the treatment cards represents a royalty fee paid to the supplier. Nowhere in the Taxpayer's documentation is there mention of a royalty fee, or that the "Refractive Per-Procedure Fee" is a fee for using supplier's intellectual property. However, even if the Department were to accept that some portion of the cost of the treatment cards represents a royalty fee paid to Taxpayer's supplier, the Department notes that to consider the "Refractive Per-Procedure Fee," as a royalty fee charged as part of the cost of the treatment cards, is unreasonable.

Taxpayer provided, at the Department's request, a letter, dated April 5, 2004, that presents the supplier's terms for a proposed buyout by Taxpayer of the lease agreement. The letter describes various pieces of equipment whose ownership the supplier proposes to assign to Taxpayer. There is no mention in the letter of the

direct cost of this equipment to Taxpayer. The letter sets out agreement to service the various pieces of equipment that are to be assigned to Taxpayer for a total service cost of $89,000 over a 36-month period. Also, the letter lists "disposable products for the refractive equipment" and their prices "for a period of three years effective May 1, 2004." The list contains two different per-procedure treatment cards: "Planoscan Treatment Card" priced at $150 each and sold in quantities of 20, and "Zyoptix Treatment Card" priced at $250 each and sold in quantities of 10.

The Department presumes that the terms of this proposed buyout were accepted by Taxpayer since Taxpayer provided the document. However, the Department was not actually provided a buyout agreement containing signatures of both parties. Assuming the terms were accepted by Taxpayer, the quoted prices would have been effective for the years in protest. Nonetheless, there is still a question of whether or not the price of the cards still includes in part the "Refractive Per-Procedure Fee" described in the 2000 lease agreement discussed above. If the price of the treatment cards does indeed include the "Refractive Per-Procedure Fee," Taxpayer has not presented any information that breaks down what percentage of the cost of the cards is represented by that fee, nor has it established that the "Refractive Per-Procedure Fee" is indeed a royalty fee.

If the definitions of the lease agreement still apply, either one-hundred percent or ninety percent, of the $129,000 over 36-months, is a "royalty fee," and, therefore, as intangible personal property, not subject to Indiana sales or use tax.

The Department finds that Taxpayer's characterization of the cost of the cards as royalty fees and therefore not subject to sales tax is unreasonable, given the particular structure of the lease agreement and the subsequent buyout of the lease. This arrangement represents an elevation of form over substance. When Taxpayer does not directly pay for the laser equipment it uses, it cannot then claim that the cost of the treatment cards it uses, which by definition of the lease agreement are necessary to the performance of refractive procedures, are simply royalty fees.

In conclusion, the Department finds Taxpayer's argument to be one of form over substance not reflecting the reality of the retail sale of tangible personal property. Taxpayer has not sustained its burden to substantiate its protest that the cost of the treatment cards is per-procedure royalty fees.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration – Imposition of Negligence Penalty.

DISCUSSION

The Taxpayer also protested 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.

Taxpayer has not affirmatively established, as required by 45 IAC 15-11-2(c), that its failure to pay sales tax on the purchase of the cards was due to reasonable cause and not due to negligence.

FINDING

Taxpayer's protest is denied.

Posted: 07/02/2008 by Legislative Services Agency
An html version of this document.