DEPARTMENT OF STATE REVENUE

04-20070408.LOF

Letter of Findings: 07-0408
Gross Retail Tax
For the Years 2003, 2004, and 2005

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ISSUES

I. Production Equipment – Sales/Use Tax.

Authority: IC § 6-2.5-1-1 et seq.; IC § 6-2.5-5-3; IC § 6-2.5-5-3(b); IC § 6-8.1-5-1(b).

Taxpayer argues that the Department of Revenue erred in determining that certain equipment was subject to sales/use tax because the equipment is used in the direct production of its automobile products and parts.

II. Safety Equipment – Sales/Use Tax.

Authority: IC § 6-8.1-5-1(b); 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(c)(2); 45 IAC 2.2-5-8(c)(2)(F).

Taxpayer maintains that certain items of its equipment are not subject to the state gross retail tax because the items are exempt "safety clothing or equipment."

III. Labels– Sales/Use Tax.

Authority: IC § 6-2.5-5-6; IC § 6-8.1-5-1(b).

Taxpayer maintains that labels are exempt from sales/use tax pursuant to "Department policies."

IV. Materials Incorporated Into Realty – Sales/Use Tax.

Authority: 45 IAC 2.2-3-8(a).

Taxpayer protests the assessment of sales tax on materials incorporated into its real property.

V. Computer Software – Sales/Use Tax.

Authority: IC § 6-2.5-4-1; IC § 6-8.1-5-1(b); Sales Tax Information Bulletin 8 (May 2002).

Taxpayer challenges the decision by the Department of Revenue finding that certain software programs are subject to sales/use tax.

VI. Uniform Rental Services – Sales/Use Tax.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-4-1; IC § 6-2.5-4-10.

Taxpayer argues that the Department of Revenue erred when it found that charges for "uniform rental" were subject to sales/use tax because the charges purportedly relate to the provision of an exempt service.

VII. Maintenance Contracts – Sales/Use Tax.

Authority: IC § 6-2.5-2-1(a); IC § 6-2.5-4-1; 45 IAC 2.2-4-2(a)

Taxpayer states that the Department of Revenue mistakenly concluded that the payments for "maintenance contracts" were subject to sales/use tax.

VIII. Temporary Storage Equipment and Facilities – Sales/Use Tax.

Authority: 45 IAC 2.2-5-8(e); *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399 (Ind. Tax Ct. 1991).

Taxpayer maintains that the Department of Revenue erred when it concluded certain storage equipment, equipment used to store "work-in-process," and various storage containers were subject to Indiana sales/use tax.

IX. Testing and Inspection Equipment – Sales/Use Tax.

Authority: 45 IAC 2.2-5-8(j).

Taxpayer argues that the Department of Revenue mistakenly concluded that a software program was subject to sales/use tax on the ground that the software program constitutes "testing equipment" used to determine if its products conform to factory specification.

X. Property Directly Consumed in Manufacturing – Sales/Use Tax.

Authority: IC § 6-2.5-5-5.1.

Taxpayer maintains that it acquired tangible personal property which was consumed in its manufacturing process and that this property is therefore exempt from sales/use tax.

XI. Negligence Penalty.

Authority: IC § 6-8.1-5-1(b); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(a)(4); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer asks the Department to exercise its discretion to abate the ten-percent negligence penalty on the ground that taxpayer exercised reasonable business care both in paying sales tax and self-assessing use tax.

STATEMENT OF FACTS

Taxpayer is a general partnership headquartered outside Indiana. Taxpayer operates four manufacturing facilities within the state producing parts for major automobile manufacturers. The Indiana Department of Revenue (Department) conducted an audit review of taxpayer's business and tax records. At the time of the audit, the Department found that taxpayer had made purchases for which it should have paid sales tax. In addition, the

Department considered taxpayer's contention that it had paid sales tax on various purchases for which it was entitled to a refund because the purchases were not subject to sales tax. As a result, the Department issued notices of proposed assessment for additional sales/use tax. The taxpayer disagreed arguing that a correct review of its purchases would have actually resulted in a net refund of sales/use tax. Taxpayer submitted a protest to that effect, and an administrative hearing was conducted during which taxpayer's representatives explained the basis for that protest. This Letter of Findings results.

I. Production Equipment – Sales/Use Tax.

DISCUSSION

Indiana imposes a sales tax on retail transactions and a complimentary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq. However, Indiana provides a number of exemptions one of which is found at IC § 6-2.5-5-3. "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." IC § 6-2.5-5-3(b) (*Emphasis added*).

Taxpayer also points out IC § 6-2.5-5-5.1(b) as support for its position that the equipment, products, and items at issue are exempt.

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture. This exemption includes transactions involving acquisitions of tangible personal property used in commercial printing.

When a taxpayer challenges a tax assessment, it is up to the taxpayer to demonstrate that the assessment is incorrect. "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC § 6-8.1-5-1(b).

Taxpayer has met its burden of demonstrating that "400W Superwatt Light Fixtures" (Page 10 of the Audit Report) are exempt. The fixtures are used to "cure" rubber/plastic parts during the production process. Therefore, the cited light fixtures have a direct effect on the taxpayer's products. In addition, taxpayer has met its burden of demonstrating that the "Preheat Oven, Conveyor" (Page 18 of the Audit Report) is similarly exempt from sales/use tax. As taxpayer explains, "the conveyor moves the injection rubber strips and plugs through the oven to preheat them before they are loaded into the molds for further processing." Taxpayer is also sustained as to the "Block Dry-Ice Blast System" (Page 14 of the Audit Report). This device uses dry ice pellets directed in a high-velocity airflow to remove unwanted "flashing" on rubber parts during the production process.

Taxpayer cites to numerous other items of equipment and argues that the items are exempt pursuant to IC § 6-2.5-5-3(b) or IC § 6-2.5-5-5.1(b). However, taxpayer has not met its burden of demonstrating that these items are exempt pursuant to either of the cited exemption statutes.

FINDING

Taxpayer's protest is sustained as to the "400W Superwatt Light Fixtures," "Block Dry-Ice Blast System," and "Preheat Oven, Conveyor." The remainder of the protest relevant to this particular sales/use tax exemption provision is denied.

II. Safety Equipment – Sales/Use Tax.

DISCUSSION

Certain types of equipment, which constitute essential and integral parts of the integrated production process, are exempt. 45 IAC 2.2-5-8(c) "The fact that such equipment may not touch the work-in-progress or, by itself, cause a change in the product, is not determinative." 45 IAC 2.2-5-8(c)(2). "Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production" is exempt. 45 IAC 2.2-5-8(c)(2)(F).

Pursuant to IC § 6-8.1-5-1(b), taxpayer has met its burden of demonstrating that the following items are exempt "safety equipment." "Light Curtains" (Page 11 of the Audit Report) and "Light Curtains" (Page 18 of the Audit Report). As taxpayer explained, the "Light Curtains" are "attached to press equipment [which] shuts downs machines when someone's hands get[] too close." In addition, taxpayer has supplied information obtained from the original vendor which substantiates the nature and use of these "Light Curtains." The "Light Curtains" are exempt because they "allow a worker to participate in the production process without injury...." 45 IAC 2.2-5-8(c)(2)(F).

FINDING

Taxpayer's protest is sustained as to the "Light Curtains." The remainder of the taxpayer's protest is denied.

III. Labels– Sales/Use Tax.

DISCUSSION

Taxpayer argues that its purchase of labels is exempt pursuant to "department policies." Presumably, taxpayer argues for application of IC § 6-2.5-5-6 which states in part as follows:

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person

acquiring the property acquires it for incorporation as a material part of other tangible personal property which the purchaser manufactures, assembles, refines, or processes for sale in his business.

The Department is unable to agree that taxpayer has met its burden under IC § 6-8.1-5-1(b) sufficient to conclude that the labels constitute a "material part" of the taxpayer's automobile parts.

FINDING

Taxpayer's protest is respectfully denied.

IV. Materials Incorporated Into Realty – Sales/Use Tax.

DISCUSSION

Taxpayer argues that materials which it purchased and incorporated into its real property are not subject to sales/use tax. The exemption on which taxpayer relies is set out in 45 IAC 2.2-3-8(a) as follows:

> In general, all sales of tangible personal property are taxable, and all sales of real property are not taxable. The conversion of tangible personal property into realty does not relieve the taxpayer from a liability for any owing and unpaid state gross retail tax or use tax with respect to such tangible personal property. (b) All construction material purchased by a contractor is taxable either at the time of purchase, or if purchased exempt (or otherwise acquired exempt) upon disposition unless the ultimate recipient could have purchased it exempt.

Taxpayer apparently argues that any tangible personal property incorporated into realty is per se exempt from sales/use tax. However, the regulation contradicts taxpayer's basic premise. Taxpayer has failed to meet its burden of demonstrating that it is entitled to the exemption set out at 45 IAC 2.2-3-8 because there is nothing which establishes that the original contractor paid sales tax at the time it acquired the tangible personal property.

FINDING

Taxpayer's protest is respectfully denied.

V. Computer Software – Sales/Use Tax.

DISCUSSION

Taxpayer maintains that its acquisition of computer software is exempt from sales tax because – according to taxpayer – the software is "custom-made" or the charges were actually for the modification its "high end business software."

Sales Tax Information Bulletin 8 (May 2002) discusses the application of the gross retail tax to the sale, lease, and use of computers and computer related equipment. In part, that Bulletin states as follows:

> 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. Pre-written programs, 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. Pre-written or canned computer programs are taxable because the intellectual property contained in the canned program is no different than the intellectual property in a videotape or a textbook. *See* IC § 6-2.5-4-1.

Taxpayer argues that the referenced software packages are exempt because "they are primarily custom-made software and/or changes related to modification of high end business software designed for the needs of [taxpayer] in which the source code is rewritten to meet the needs of manufacturing facilities in Indiana."

Taxpayer has failed to meet its burden under IC § 6-8.1-5-1(b) of demonstrating that it purchased "custom-made software" for which it was entitled to a sales tax exemption.

FINDING

Taxpayer's protest is denied.

VI. Uniform Rental Services – Sales/Use Tax.

DISCUSSION

Retail transactions made in Indiana are subject to sales tax. IC § 6-2.5-2-1. A retail transaction is defined generally as the acquiring and subsequent selling of tangible personal property. IC § 6-2.5-4-1. Sales of services are generally not retail transactions and are not subject to sales tax.

Taxpayer points to numerous payments it made to a vendor for "uniform rental." Taxpayer maintains that this is a service exempt pursuant to IC § 6-2.5-4-1. However, IC § 6-2.5-4-10 provides in part that "A person, other than a public utility, is a retail merchant when he rents or leases tangible personal property to another person other than for subrent or sublease."

The Department is unable to agree that the rental of uniforms constitutes an exempt service. Taxpayer properly paid sales tax at the time it paid for these rental transactions.

FINDING

Taxpayer's protest is respectfully denied.

VII. Maintenance Contracts – Sales/Use Tax.

DISCUSSION

Taxpayer maintains that payments it made on a maintenance contracts are exempt. IC § 6-2.5-2-1(a) imposes a sales tax on retail transactions made in Indiana. IC § 6-2.5-4-1 provides that a retail transaction occurs

when a seller "acquires tangible personal property for the purpose of resale; and... transfers that property to another for consideration." IC § 6-2.5-4-1(b).

Nonetheless 45 IAC 2.2-4-2(a) in part states that, "Professional services, personal services, and services in respect to property not owned by the person rendering such services are not 'transactions of a retail merchant constituting selling at retail,' and are not subject to gross retail tax."

The issue is whether the maintenance agreements into which taxpayer entered were subject to sales tax or whether the agreements merely constitute exempt contracts for the provision of professional services.

Taxpayer has cited to a line item labeled "Main[tenance] Contract" and asks the Department to conclude – on that scanty evidence – that this line particular item constitutes a charge for professional services. The Department is unable to agree that taxpayer has met its burden of demonstrating that the maintenance agreements constitute exempt contracts for the provision of professional services.

FINDING

Taxpayer's protest is respectfully denied.

VIII. Temporary Storage Equipment and Facilities – Sales/Use Tax.

DISCUSSION

Taxpayer argues that certain items of its equipment and facilities are exempt from sales tax because the equipment is used to temporarily store raw materials and partially finished products with taxpayer's production process. As support for this assertion, taxpayer cites to 45 IAC 2.2-5-8(e) as follows:

> Storage equipment. Tangible personal property used in or for the purpose of storing raw materials or finished goods is subject to tax except for temporary storage equipment necessary for moving materials being manufactured from one (1) machine to another or from one (1) production step to another.
>
> (1) Temporary storage. Tangible personal property used in or for the purpose of storing work-in-process or semi-finished goods is not subject to tax if the work-in-process or semi-finished goods are ultimately completely produced for resale and in fact resold.
>
> (2) Storage containers for finished goods after completion of the production process are subject to tax.
>
> (3) Storage facilities or containers for materials or items currently undergoing production during the production process are deemed temporary storage facilities and containers and are not subject to tax.

Taxpayer argues that categories of "returnable containers" are exempt because the containers are used to "contain 50 [percent] raw materials from other vendors and used 50 [percent] to move in-process products between work cells within the production process." Taxpayer's argument is apparently predicated on the assumption that its four production facilities constitute a "continuous integrated production process" as set out in *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991). However, the Department is unable to agree that taxpayer has met the standard the Tax Court established in *General Motors* sufficient to establish that taxpayer's four facilities form a unified production facility. *See Id*. 402 at n.3.

Because taxpayer has not met its burden of demonstrating that the four production facilities constitute a "continuous integrated production process" and that the "returnable containers" are used *within* that production process, taxpayer has failed to establish that it is entitled to the exemption it seeks.

FINDING

Taxpayer's protest is respectfully denied.

IX. Testing and Inspection Equipment – Sales/Use Tax.

DISCUSSION

Taxpayer argues that it purchased computer software for use within its testing and inspection process. Taxpayer concludes that the software is not subject to sales/use tax pursuant to 45 IAC 2.2-5-8(i) which states that, "Testing and inspection: Machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt."

Taxpayer explains that the software is used to perform various strain and temperature tests on its manufactured products. According to taxpayer, "If the product does not conform to the required specifications, the manufacturing process will be changed to conform to the required specifications."

Specifically, taxpayer argues that its "RPA Pathfinder Software" (Page 17 Audit Report) is exempt. According to taxpayer, the software is "Used in the testing of rubber components for quality and conformity based on customer specifications. [The software] perform[s] the patented 'single sample' analysis which allows frequency, strain, and temperature to be varied during a single test and provides the comprehensive data required for production control."

The Department is prepared to agree that the "RPA Pathfinder Software" constitutes exempt equipment used to determine if taxpayer's products conform to the necessary specifications and is used to adjust taxpayer's manufacturing process.

FINDING

Taxpayer's protest is sustained as to the RPA Pathfinder Software.

X. Property Directly Consumed in Manufacturing – Sales/Use Tax.

DISCUSSION

Taxpayer states that it purchased various items which are consumed during the manufacture of its

automobile parts. Taxpayer concludes that these items are exempt pursuant to IC § 6-2.5-5-5.1 which reads as follows:

> As used in this section, "tangible personal property" includes electrical energy, natural or artificial gas, water, steam, and steam heat. (b) Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture.

Taxpayer argues that purchases of "mold release spray" and "mold release cleaner" (Pages 15, 27, 28, 38) are exempt because the items are consumed in the production of taxpayer's automobile parts. The Department is prepared to agree that the "mold release spray" and "mold cleaning" supplies are directly used in the production of taxpayer's automobile parts and that they are essential to the production of those parts. However, taxpayer is sustained only as to purchases listed on audit pages 27 and 28 because the other listings consist of both "maintenance" and "miscellaneous" items.

FINDING

Taxpayer's protest is sustained as to the "mold release spray" and "mold cleaning" supplies found on pages 27 and 28.

XI. Ten-Percent Negligence Penalty.

DISCUSSION

Taxpayer believes that it is entitled to abatement of the ten-percent negligence penalty because it did not willfully underpay sales and use tax and that any underpayments were not the result of taxpayer's willful neglect.

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(4) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to... pay the full amount of tax shown on the person's return... or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty."

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." *Id*.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that 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 IC § 6-8.1-5-1(b), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment – including the negligence penalty – is presumptively valid.

Given the sheer number of items for which taxpayer failed to self-assess use tax, the Department is unable to agree that the taxpayer exercised ordinary business care in determining its use tax liabilities.

FINDING

Taxpayer's protest respectfully denied.

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