DEPARTMENT OF STATE REVENUE

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Letter of Findings: 09-0683
Sales and Use Tax
For the Years 2006 through 2008

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ISSUES

I. Exempt Manufacturing Usage – Gross Retail Tax.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-2(a); IC § 6-8.1-5-1(c); 45 IAC 2.2-3-9; Sales Tax Information Bulletin 60 (July 2006).

Taxpayer argues that the Department of Revenue's audit erred when it determined that twenty-nine percent of its activities were properly classified as "manufacturing" and seventy-one percent of its activities should be classified as entering into "lump-sum contracts."

II. Utility Exemption – Gross Retail Tax.

Authority: IC § 6-2.5-4-5(c)(3); IC § 6-8.1-5-1(c); 45 IAC 2.2-4-13.

Taxpayer states that it is entitled to the "predominant" use utility exemption.

III. Administration – Interest and Negligence Penalty.

Authority: IC § 6-8.1-5-1(c); 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 of Revenue to abate the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana business which designs and manufactures custom furniture. The Department of Revenue (Department) conducted an audit review of Taxpayer's business records and concluded that Taxpayer owed additional sales and use tax. Taxpayer disagreed with the assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Exempt Manufacturing Usage – Gross Retail Tax.

DISCUSSION

Taxpayer designs and manufactures furniture. The Department's audit found that under certain circumstances, Taxpayer functions as a "manufacturer" because it builds a particular item of furniture and then sells that same item to a retail customer. Based on its review of Taxpayer's sales records, the audit determined that twenty-nine percent of the time, Taxpayer was acting as a manufacturer.

The audit also found that for the remainder of the time, Taxpayer was acting as "a subcontractor when making improvements to realty" and that these improvements were made on a "lump sum basis."

The audit found that to the extent Taxpayer entered into lump sum contracts with its customers, Taxpayer was subject to use tax on the equipment and expendable materials Taxpayer purchased to perform those contracts. The audit concluded that because Taxpayer was acting as a contractor seventy-one percent of the time, it was required to pay sales tax at the time it purchased those items or to self-assess use tax. Taxpayer maintains that because it was acting as a contractor on behalf of a number of exempt organizations, the equipment and expendables were entitled to a supplementary exemption. In other words, because Taxpayer entered into lump sum contracts with exempt organizations, the "seventy-one percent" figure overstates Taxpayer's sales and use tax liability.

It should be noted that Taxpayer correctly charged its retail customers sales tax. The issue is whether the audit correctly and accurately distinguished the degree to which Taxpayer was functioning as a "manufacturer" as opposed to acting as a contractor entering into "lump sum contracts."

The audit found the distinction between "manufacturing" and "lump sum" significant concluding that Taxpayer should have been self-assessing use tax on the tools and expendable materials used in those lump sum contracts. Taxpayer disagrees based on the following argument. Taxpayer maintains that when it performs "lump sum" contracts for exempt organizations, that it should not be required to self-assess use tax on the items necessary to fulfill the contracts with exempt organizations. Therefore, according to Taxpayer, the amount of use tax assessed should be reduced in proportion to the number of "lump sum" contracts it performs for exempt organizations.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "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."

Pursuant to IC § 6-2.5-2-1, a sales tax, known as state gross retail tax, is imposed on retail transactions

made in Indiana unless a valid exemption is applicable. Retail transactions involve the transfer of tangible personal property. IC § 6-2.5-3-2(a). A complementary 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. IC § 6-2.5-3-2.

Specifically, IC § 6-2.5-2-1 provides as follows:

(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 for the complementary use tax:

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.

45 IAC 2.2-3-9 states as follows:

(a) A contractor may purchase construction material exempt from the state gross retail tax only if he issues either an exemption certificate or a direct pay certificate to the seller at the time of purchase.

(b) A contractor who purchases construction material exempt from the state gross retail tax or otherwise acquires construction material "tax-free," is accountable to the Department of Revenue for the state gross retail tax when he disposes of such property.

(c) A contractor has the burden of proof to establish exempt sale or use when construction material, which was acquired tax-free, is not subject to either the state gross retail or use tax upon disposition.

(d) Disposition subject to the state gross retail tax. A contractor-retail merchant has the responsibility to collect the state gross retail tax and to remit such tax to the Department of Revenue whenever he disposes of any construction material in the following manner:

(1) Time and material contract. He converts the construction material into realty on land he does not own and states separately the cost for the construction material and the cost for the labor and other charges (only the gross proceeds from the sale of the construction materials are subject to tax), or

(2) Construction material sold over-the-counter. Over the counter sales of construction materials will be treated as exempt from the state gross retail tax only if the contractor receives a valid exemption certificate issued by the person for whom the construction is being performed or by the customer who purchases over-the-counter, or a direct pay permit issued by the customer who purchases over-the-counter.

(e) Disposition subject to the use tax. With respect to construction materials a contractor acquired tax-free, the contractor is liable for the use tax and must remit such tax (measured on the purchase price) to the Department of Revenue when he disposes of such property in the following manner:

(1) He converts the construction material into realty on land he owns and then sells the improved real estate;

(2) He utilizes the construction material for his own benefit; or

(3) Lump sum contract. He converts the construction material into realty on land he does not own pursuant to a contract that includes all elements of cost in the total contract price.

(f) A disposition under... [subsection (e)(3) of this section] will be exempt from the use tax only if the contractor received a valid exemption certificate, not a direct pay permit, from the ultimate purchaser or recipient of the construction material (as converted), provided such person could have initially purchased such property exempt from the state gross retail tax.

The dispute centers on Taxpayer's "lump sum" contracts. The Department has defined what a "lump sum contract" means at Sales Tax Information Bulletin 60 (July 2006).

"Lump sum contract" is a contract in which all of charges are quoted as a single price. A construction contractor may furnish a breakdown of the charges for labor, materials and other items without changing the nature of the lump sum contract.

It is not disputed that Taxpayer entered into lump sum contracts. It quoted a single price for the construction and installation of custom designed woodwork, furniture, and other improvements for certain of its customers.

Sales Tax Information Bulletin 60 also explains the tax consequences of these forms of contracts.

If a construction contractor purchases construction materials pursuant to a lump sum contract, the construction contractor pays either: (1) sales tax at the time the construction materials are purchased, or (2) use tax at the time the construction materials are incorporated into real property if the contractor purchased or acquired the construction materials exempt from sales tax and the owner of the real property could not have purchased the materials exempt from sales tax.

Therefore, a lump sum contractor pays sales tax at the time it purchases materials necessary to fulfill those contracts unless the customer issues the contractor an exemption certificate. On this particular issue, Taxpayer and the Department agree.

However, Taxpayer asks that the Department expand the reach of the exemption provision found at 45 IAC 2.2-3-9(f). Although the Department agrees that a contractor fulfilling a lump sum contract with an exempt entity,

is entitled to purchase the materials used to fulfill that contract, there is no parallel provision which exempts the tools, equipment, and expendables used to perform that contract. In other words, if a lump sum contractor purchased lumber and other construction materials which was incorporated into the exempt customer's property, the contractor is not required to self-assess use tax on those materials. However, the band-saw, hammer, drill, and other tools and expendables used to perform that particular contract are not exempt.

In this case, the audit correctly differentiated between the sales and use tax and the consequences of acting as a manufacturer and acting as a lump sum contractor. Taxpayer is asking for more than the exemption provision allows. Taxpayer has not met its burden of demonstrating that the audit assessments were wrong.

FINDING

Taxpayer's protest is respectfully denied.

II. Utility Exemption – Gross Retail Tax.

DISCUSSION

Taxpayer had earlier submitted a 2005, 2006, and 2007 utility exemption based on a usage study it had previously conducted. Taxpayer's utility study concluded that Taxpayer's utilities were used for exempt purposes sixty-four percent of the time and that it was therefore entitled to the "predominate" use exemption. Based on that study, Taxpayer's request for a refund of sales tax previously paid was approved and Taxpayer was issued a refund check.

During the audit, the Department concluded that Taxpayer had overstated its exempt usage. As noted above in Part I of this Letter of Findings, the Department calculated that Taxpayer was acting as a "manufacturer" twenty-nine percent of the time – measured on the extent to which Taxpayer entered into retail transactions – and that taxpayer acted as a "contractor" the remaining seventy-one percent of the time. Therefore, the audit concluded that Taxpayer should be reassessed a portion of the previously paid refund.

Taxpayer's argument is as follows:

Accept Utility Exemption for sales tax based on proof of utility exemption per Form GA-110L State Form 154 filed 11/19/08 and approved by IDOR 1/26/09. IDOR analysis based on energy hours used with manufacturing equipment in shop verses office equipment in terms of amps and hours.

The standard of proof remains unchanged. Under IC § 6-8.1-5-1(c), "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." In this case, Taxpayer is required to demonstrate that the audit's conclusion was "wrong."

45 IAC 2.2-4-13 explains the exemption Taxpayer seeks:

(a) In general, the furnishing of electricity, gas, water, steam, or steam heating services by public utilities to consumer is subject to tax.

(b) The gross receipt of every person engaged as a power subsidiary or a public utility derived from selling electrical energy gas, water, or steam to consumers for direct use in direct manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in IC 6-2.5-4-5 shall not constitute gross retail income of a retail merchant received from a retail transaction. Electrical energy, gas, water, or steam will only be considered directly used in direct production, manufacturing, mining, refining, oil or mineral extraction, irrigation, agriculture, or horticulture if the utilities would be exempt under IC 6-2.5-5-5.1.

(c) Sales of public utility services or commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in IC 6-2.5-4-5, based on a single meter charge, flat rate charge, or other charge, are excepted if such services are separately metered or billed and will be used predominantly for the excepted purposes.

(d) Sales of public utility services and commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, or horticulture, based on a single meter charge, flat rate charge, or other charge, which will be used for both excepted and nonexcepted purposes are taxable unless such services and commodities are used predominantly for excepted purposes.

(e) Where public utility services are sold from a single meter and the services or commodities are utilized for both exempt and nonexempt uses, the entire gross receipts will be subject to tax unless the services or commodities are used predominantly for excepted purposes. Predominant use shall mean that more than fifty percent (50 [percent]) of the utility services and commodities are consumed for excepted uses. See also IC § 6-2.5-4-5.

Taxpayer's argument is apparently based on the proposition that certain of its "lump sum" contracts are entered into with exempt organizations and that it is entitled to an exemption over-and-above to which it is entitled to as a "manufacturer." However, the utility exemption is only applicable to those entities which are engaged in "manufacturing, mining, production, refining, oil extraction, mineral extraction, irrigation, agriculture, or horticulture." IC § 6-2.5-4-5(c)(3).

The audit found that Taxpayer was acting as a "manufacturer" twenty-nine percent of the time and correctly adjusted the utility exemption to comport with that finding. Taxpayer has not proved that the "proposed

assessment is wrong." IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is respectfully denied.

III. Administration – Interest and Negligence Penalty.

DISCUSSION

Taxpayer believes that it is entitled to abatement of the ten-percent negligence penalty "based on a timely payment history and confusion of tax laws."

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(c), "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.

The Department believes that taxpayer erred in determining its sales and use tax liability. However, there is insufficient information to establish that Taxpayer's position was so egregious as to constitute "willful neglect." Based on a "case-by-case" analysis and after reviewing "the facts and circumstances of each taxpayer" the Department agrees that the ten-percent negligence penalty should be abated.

However, Taxpayer's related request – that the interest charges be abated – is not sustained. Under IC § 6-8.1-10-1, interest is not abated for any reason.

FINDING

Taxpayer's protest is sustained in part and denied in part. The ten-percent negligence penalty is abated but the interest charges are not abated.

SUMMARY

Except to the extent that Taxpayer disagreed with the assessment of the ten-percent negligence penalty, Taxpayer's protest is denied in its entirety.

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