DEPARTMENT OF STATE REVENUE

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Supplemental Letter of Findings: 10-0008
Gross Retail Tax
For 2006 through 2008

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ISSUES

I. Extended Maintenance Warranties – Gross Retail Tax.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2(a); IC § 6-2.5-4-1; IC § 6-8.1-5-1(c); 45 IAC 2.2-4-2; Sales Tax Information Bulletin 2 (December 2006).

Taxpayer maintains that the original Letter of Findings incorrectly found that Taxpayer should have collected sales tax on the sale of extended automobile warranties.

II. Administration – Ten-Percent 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 that the Department exercise its discretion to abate the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana business which sells used and new cars. The Indiana Department of Revenue (Department) conducted an audit review of Taxpayer's business records. As a result of that review, the Department assessed additional withholding, gross retail, and tire fees. Taxpayer disagreed with portions of the assessments and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the initial protest. A Letter of Findings was issued March 2010 in which Taxpayer's protest was denied in part and sustained in part. Taxpayer asked for and was granted the opportunity to revisit two of the issues addressed in the March Letter of Findings. A second administrative hearing was conducted during which Taxpayer's representative reiterated and further explained Taxpayer's objections. This Supplemental Letter of Findings results.

I. Extended Maintenance Warranties – Gross Retail Tax.

DISCUSSION

Taxpayer sold its new and used car customers optional, extended warranties. Under the terms of the warranties, and according to the audit report, "parts and services would be provided by the taxpayer in the event of a break down or malfunction of the covered part." Taxpayer charged its warranty customers a "lump sum" which included the cost of both service and parts. Taxpayer did not collect sales or use tax on the warranties. The Department made "an adjustment to assess sales tax on the optional warranties under [45 IAC 2.2-4-2]."

As with Taxpayer's initial protest, 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). IC § 6-2.5-4-1 defines "retail transactions" stating in part as follows:

(a) A person is a retail merchant making a retail transaction when he engages in selling at retail.

(b) A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business he:

(1) acquires tangible personal property for the purpose of resale; and

(2) transfer that property to another for consideration.

(c) For purposes of determining what constitutes selling at retail, it does not matter whether:

(1) the property is transferred in the same form as when it was acquired;

(2) the property is transferred alone or in conjunction with other property or services; or

(3) the property is transferred conditionally or otherwise.

Here, Taxpayer is purportedly the "retail merchant" selling "tangible personal property" in conjunction with "other property or services."

The Department has addressed the issue of optional maintenance agreements in Sales Tax Information Bulletin 2 (December 2006) which states in part as follows:

Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are subject to sales tax if there is a reasonable expectation that tangible personal property will be provided. Any parts or tangible personal property supplied pursuant to this type of agreement are not subject to sales or use tax. The supplier of the parts or property is not liable for the use tax on the parts or

property because the supplier is using the material to fulfill the service called for by the terms of the warranty or maintenance agreement. A merchant that maintains an inventory of parts for resale and uses some of the parts in fulfilling the terms of the warranty or maintenance agreement is not required to self assess use tax on any parts so used. (Emphasis added).

Taxpayer provided a sample copy of its warranty agreement along with a more detailed description of its "Preferred Customer Vehicle Protection Plan Coverage." The warranty document stipulates that the agreement between the parties "is not an Insurance Policy." Depending on the level of coverage chosen, the warranty coverage includes: (1) engine components such as the cylinder block, cylinder heads, rotor housing, intake manifold, timing gears, timing chain or belt, valve covers, flywheel, oil pump, fuel pump, vacuum pump, oil pan, thermostat, turbochargers, intercooler, and engine mounts. The warranty coverage includes: (2) transmission components such as transmission case, transaxle case, transfer case, torque convertor, vacuum modulator, cooler, cooler lines, and transmission parts. The warranty coverage includes: (3) "front or rear wheel drive" parts such as final drive, axle housing, flex disc, axle shafts, bearings, universal joints, constant velocity joints, drive shaft, center bearings, and drive shaft yokes. In addition – in the case of new car warranties – the warranty also includes: (4) a "seals and gaskets packages" which covers cylinder head gaskets, intake manifold gaskets, exhaust manifold gaskets, rear main seal, valve cover gaskets, oil pan gaskets, front crankshaft seal, timing cover gasket, and cam housing gaskets.

The details of the warranty coverage listed above describes the basic "Bronze Preferred Coverage." The "Gold" and "Platinum" coverage provide broader coverage and includes additional parts such as "powertrain electronics."

Taxpayer points to the Department's regulation, 45 IAC 2.2-4-2, in support of its proposition that the sale of the warranties is not a "retail transaction" in which the customer obtains tangible personal property. The regulation states as follows:

(a) 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. Where, in conjunction with rendering professional services, personal services, or other services, the serviceman also transfers tangible personal property for a consideration, this will constitute a transaction of a retail merchant constituting selling at retail unless:

(1) The serviceman is in an occupation which primarily furnishes and sells services, as distinguished from tangible personal property;

(2) The tangible personal property purchased is used or consumed as a necessary incident to the service;

(3) The price charged for tangible personal property is inconsequential (not to exceed 10 [percent]) compared with the service charge; and

(4) The serviceman pays gross retail tax or use tax upon the tangible personal property at the time of acquisition.

(b) Services performed or work done in respect to property and performed prior to delivery to be sold by a retail merchant must however, be included in taxable gross receipts of the retail merchant.

(c) Persons engaging in repair services are servicemen with respect to the services which they render and retail merchants at retail with respect to repair or replacement parts sold.

(d) A serviceman occupationally engaged in rendering professional, personal or other services will be presumed to be a retail merchant selling at retail with respect to any tangible personal property sold by him, whether or not the tangible personal property is sold in the course of rendering such services. If, however, the transaction satisfies the four (4) requirements set forth in 6-2.5-4-1(c)(010), paragraph (1) [subsection (a) of this section], the gross retail tax shall not apply to such transaction.

Taxpayer's arguments are as follows; the warranty contracts are not subject to sales tax because the warranty itself "is not the sale of tangible personal property" and that Taxpayer paid use tax on those parts which were supplied to its warranty customers. The second reason is that the cost of the parts was minimal when compared to the price of the warranty contracts. Taxpayer buttresses this secondary argument by explaining that in 2005 Taxpayer sold approximately $393,000 in warranty contracts but only spent $550 for parts to fulfill the terms of the existing warranties; in 2006 Taxpayer sold approximately $617,000 in warranty contracts but only spent $189 for parts to fulfill the terms of the warranties; in 2007 Taxpayer sold approximately $757,000 in warranty contracts but only spent $2,200 for parts to fulfill the terms of the warranties; in 2008 taxpayer sold approximately $501,000 in warranty contracts but only spent $790 for parts to fulfill the terms of the warranties. As noted by Taxpayer, "the cost of the parts used in servicing these contracts was less than 3 [percent] (almost zero in 2006) of the revenue from the sale of these contracts which suggest that there was a reasonable expectation that tangible personal property would not be provided...." (Emphasis added).

As Taxpayer summarizes, "[T]he property provided by taxpayer represented.14 [percent],.03 [percent],.29 [percent], and.16 [percent] of the revenue from the sale of the extended warranty contracts from 2005 to 2008."

For the sake of clarity, it should be noted that most of the revenue Taxpayer received for the sale of the warranties was not retained by Taxpayer. According to Taxpayer, "[It] only took applications for the sellers... and the Taxpayer received only a commission on the sale...."

The apparent economic reality underlying Taxpayer's warranties poses a dilemma. Based on the information provided by Taxpayer, its customers have no reasonable expectation that car parts will be provided; in each of the years under review, substantially less than one percent of the money received from the sale of the warranties was used to purchase car parts necessary to fulfill the terms of the warranty contracts. The issue is whether Taxpayer was providing a service or did Taxpayer's customers expect that they were purchasing a promise to deliver car parts as those parts were needed.

In this case, the terms of the warranty contract appear dispositive. The contracts themselves caution that the contract is not an "Insurance Policy" but clearly lead to the reasonable expectation that the customers will receive "engine components," "transmission components," "front or rear wheel drive" parts, "seals and gasket[] packages," and "powertrain electronics." Despite the apparent fact that the likelihood of the customers actually receiving these parts was miniscule, the Department believes that the terms of Taxpayer's own warranty contract governs the issue and that the explicit terms of the contract instill in Taxpayer's customers the "reasonable expectation" that they were purchasing precisely what the contract promised. In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

FINDING

Taxpayer's protest is respectfully denied.

II. Administration – Ten-Percent Negligence Penalty.

DISCUSSION

Taxpayer believes that it is entitled to abatement of the ten-percent negligence penalty because the "Taxpayer exercised the level of reasonable care, caution and diligence expected of an ordinary reasonable taxpayer, notwithstanding the challenges presented...." Taxpayer adds that, "There was no carelessness, thoughtlessness or disregard or inattention to duties on the part of the Taxpayer."

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 and that it made a more serious error in a withholding issue addressed within the original Letter of Findings but not revisited here. 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.

FINDING

Taxpayer's protest is sustained.

SUMMARY

The ten-percent negligence penalty will be abated; in all other respects, Taxpayer's protest is denied.

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