

Letter of Findings: 04-20100285
Sales and Use Tax
For the Years 2006, 2007, and 2008

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ISSUES

I. Sales and Use Tax – Imposition.

Authority: IC § 6-2.5-1-1 et seq; IC § 6-2.5-1-27; IC § 6-2.5-3-4; IC § 6-2.5-5-3; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-11](#); [45 IAC 2.2-5-12](#); [45 IAC 2.2-4-2](#); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); Microsoft Press Computer Dictionary (2d ed. 1994).

Taxpayer protests the imposition of use tax on its purchases of tangible personal property and software maintenance packages.

II. Tax Administration – Negligence Penalty.

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

Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer, an Indiana company, manufactures and sells consumer products, such as posters, calendars, and stationery. Pursuant to an audit, the Indiana Department of Revenue ("Department") assessed Taxpayer additional use tax, interest, and penalty on certain purchases during the tax years 2006, 2007, and 2008, because Taxpayer did not pay sales tax at the time of the transactions nor did it self-assess and remit use tax to the Department. The Department and Taxpayer agreed to utilize a statistical sample to establish Taxpayer's tax liabilities on its purchases.

Taxpayer timely protested the assessments. To support its protest, Taxpayer submitted pertinent documentation and directed the Department's attention to an itemized list. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Imposition.

DISCUSSION

The Department's audit assessed Taxpayer use tax on its purchases of tangible personal property. Taxpayer first claimed that it was entitled to the manufacturing exemption on several purchases. Taxpayer also asserts that it subscribes to monthly phone support services for its Electronic Data Interchange system, and as services, they are not subject to sale/use tax. Additionally, Taxpayer maintains that the Department's audit mistakenly listed one purchase twice, and as a result, the audit has assessed use tax on the same purchase twice.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid 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).

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. Generally, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable. [45 IAC 2.2-5-8](#)(a). An exemption from 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. There are also additional exemptions from sales tax and use tax. A statute which provides a tax exemption, however, is strictly construed against the taxpayer. Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96, 97 (Ind. Ct. App. 1974).

A. Manufacturing Exemptions.

The Department's audit assessed Taxpayer use tax on its purchases because Taxpayer failed to pay sales tax or self-assess and remit to the Department the use tax due. Taxpayer, to the contrary, claimed that it was entitled to the manufacturing exemptions.

IC § 6-2.5-5-3(b) states:

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 § 6-2.5-5-5.1(b) provides:

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.

An exemption applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. [45 IAC 2.2-5-8\(a\)](#). Machinery, tools, and equipment are directly used in the production process if they have an immediate effect on the article being produced. [45 IAC 2.2-5-8\(c\)](#). A machine, tool, or piece of equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. Id. An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." [45 IAC 2.2-5-8\(c\)](#), Example 1.

[45 IAC 2.2-5-8\(k\)](#) describes direct production as the performance of an integrated series of operations which transforms the matter into a form, composition or character different from that in which it was acquired, and that the change must be substantial resulting in a transformation of the property into a different and distinct product.

The exemption for direct use in production is further explained at [45 IAC 2.2-5-11](#), in part, as follows:

(a) The state gross retail tax shall not apply to sales of tangible personal property to be directly used by the purchaser in the direct production or manufacture of any manufacturing or agricultural machinery, tools, and equipment described in [IC 6-2.5-5-2](#) or 6-2.5-5-3 [[IC 6-2.5-5-3](#)].

(b) The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to tangible personal property directly used in the direct production of manufacturing or agricultural machinery, tools, and equipment to be used by such manufacturer or producer.

(c) The state gross retail tax shall not apply to purchases of tangible personal property to be directly used by the purchaser in the production or manufacturing process of any manufacturing or agricultural machinery, tools, or equipment, provided that the machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect upon the article being produced or manufactured. The 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.

(d) For the application of the rules [subsections] above, refer to Regs. 6-2.5-5-3 [[45 IAC 2.2-5-8](#) through [45 IAC 2.2-5-10](#)] with respect to tangible personal property used directly in the following activities: pre-production and post-production activities; storage; transportation; tangible personal property which has an immediate effect upon the article produced; maintenance and replacement; testing and inspection; and managerial, sales, and other nonoperational activities.

The exemption for direct consumption in production is further explained at [45 IAC 2.2-5-12](#), in part, as follows:

(a) The state gross retail tax shall not apply to sales of any tangible personal property consumed in direct production by the purchaser in the business of producing tangible personal property by manufacturing, processing, refining, or mining.

(b) The exemption provided by this regulation [[45 IAC 2.2](#)] applies only to tangible personal property to be directly consumed in direct production by manufacturing, processing, refining, or mining. It does not apply to machinery, tools, and equipment used in direct production or to materials incorporated into the tangible personal property produced.

(c) The state gross retail tax does not apply to purchases of materials to be directly consumed in the production process or in mining, provided that such materials are directly used in the production process; i.e., they have an immediate effect on the article being produced. The 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.

[45 IAC 2.2-5-8\(d\)](#) states:

Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

[45 IAC 2.2-5-8\(f\)](#) provides:

(1) Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.

(2) Tangible personal property used for moving finished goods from the plant after manufacture is subject to tax.

(3) 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.

(4) Transportation equipment used to transport work-in-process, semi-finished, or finished goods between plants is taxable, if the plants are not part of the same integrated production process.

[45 IAC 2.2-5-8\(g\)](#) further states:

"Have an immediate effect upon the article being produced": Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit.

The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced". Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property.

Additionally, [45 IAC 2.2-5-8](#)(h) provides:

- (1) Machinery, tools and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax.
- (2) Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax.

–Example–

A manufacturer of sheet metal repairs and upgrades used machinery by replacing worn or broken parts and adding new elements and features available in state-of-the-art equipment. All items which become components of the upgraded machinery are exempt from tax. However, all tools and equipment used to repair or upgrade used machinery would be taxable.

In this instance, Taxpayer protests the audit assessment on the following items.

Page	Date	Reference	Item Description	Amount
21	05/08/2008	credit card	Magnetek Inverter	\$976.33
21	07/10/2008	credit card	Top Film Drive Pulley	\$455.02
21	12/01/2008	credit card	Bearings	\$ 1,105.63
24	05/28/2008	credit card	Shipping Charges	\$ 79.95
27	10/16/2008	425	Interchangeable Roll Kit	\$12,942.29

Upon reviewing Taxpayer's documentation, Taxpayer has provided sufficient documentation to support its claim. The Department will recalculate the assessment in a supplemental audit.

B. Services.

Taxpayer claims that the Department's audit erroneously assessed use tax on various items which it purchased from a vendor for a total of \$15,625. Taxpayer argues that their charge was for phone support services for Taxpayer's Electronic Data Interchange system. Taxpayer maintains that, as services, they are not subject to sales/use tax. Taxpayer further explains that "[t]hey are not software maintenance agreements, software licenses, or user licenses," that "[t]hey do not provide for software updates, download, or patches," and that "[t]hey merely allow the Taxpayer to telephone the vendor if there are questions or issues with the system and talk to a customer service representative."

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. "Tangible personal property," as defined in IC § 6-2.5-1-27, "means personal property that: (1) can be seen, weighed, measured, felt, or touched; or (2) is in any other manner perceptible to the senses," including "electricity, water, gas, steam, and **prewritten computer software.**" (**Emphasis added**).

According to Microsoft Press Computer Dictionary, "update" is defined:

As a noun, a new release of an existing software product. A software update usually adds relatively minor new features to a product or corrects errors (bugs) found after the program was released. Updates are generally indicated by small changes in software version numbers, as in incrementing version 4.01 to 4.02. Microsoft Press Computer Dictionary 404 (2d ed. 1994).

Additionally, "patch" means:

In programming, to repair a deficiency in the functionality of an existing routine or program, generally in response to an unforeseen need or set of operating circumstances. Patching does not necessarily imply sloppiness in implementing a solution to a problem: Patching is a common means of adding a feature or a function to an existing version of a program until the next version of the software, which presumably will have that feature or function included in its design, is released. Microsoft Press Computer Dictionary 293 (2d ed. 1994).

Since a patch is a piece of software commonly used to add a feature or a function to an existing software program and usually is included into the next update, a patch to a prewritten software program is an update of the prewritten computer software. Thus, any update or updates of prewritten computer software, including patches, are tangible personal property pursuant to IC § 6-2.5-1-27.

"Unitary transaction," as defined in IC § 6-2.5-1-1(a), "includes all items of personal property and services which are furnished under a single order or agreement and for which a total combined charge or price is calculated."

[45 IAC 2.2-4-2](#) further provides an exception and, in relevant part, states:

- (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. (Emphasis added).**

Taxpayer's documentation demonstrates that it purchased pre-written software and standard updates available to be downloaded periodically. Additionally, the vendor's statement, in relevant part, provides that: [Taxpayer] also purchases a maintenance package on the [pre-written] software which gives them access to [the vendor's] e-service portal. From e-service they can download builds for the version of the software they have and new versions.

Thus, in the absence of other documentation, the Department is not able to agree that Taxpayer has met its burden. Since Taxpayer did not pay sales tax at the time of the transactions, use tax is properly imposed.

C. Duplicate Invoice.

Taxpayer also asserts that the Department's audit mistakenly assessed the same invoice twice. Upon reviewing the audit summary, the Department agrees that the same invoice was listed twice in the same report. Thus, the Department will remove one of the listings from the audit summary and recalculate Taxpayer's liability in a supplemental audit review.

In conclusion, Taxpayer has provided sufficient documentation demonstrating that it was entitled to the manufacturing exemptions on the purchases listed in Part A. Taxpayer also demonstrates that the audit mistakenly assessed use tax twice on the same invoice. However, Taxpayer fails to demonstrate that it subscribes services which were not subject to sales/use tax.

FINDING

Taxpayer's protest of the imposition of use tax is sustained in part and denied in part. Taxpayer's protest of Part A and Part C is sustained. However, Taxpayer's protest of Part B is respectfully denied. The Department will recalculate Taxpayer's liability in a supplemental audit review.

II. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayers also protest the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1(a), the Department may assess a ten (10) percent negligence penalty if the taxpayer:

- (1) fails to file a return for any of the listed taxes;
- (2) 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;
- (3) incurs, upon examination by the department, a deficiency that is due to negligence;
- (4) fails to timely remit any tax held in trust for the state; or
- (5) is required to make a payment by electronic funds transfer (as defined in [IC 4-8.1-2-7](#)), overnight courier, or personal delivery and the payment is not received by the department by the due date in funds acceptable to the department.

[45 IAC 15-11-2](#)(b) further states:

"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 Department may waive a negligence penalty as provided in [45 IAC 15-11-2](#)(c), in part, 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 audit imposed the negligence penalty because Taxpayer made numerous purchases without paying sales tax. The audit also noted that Taxpayer failed to establish a use tax accrual system and remit the use tax accordingly. Upon reviewing Taxpayer's documentation, the Department is unable to agree that Taxpayer has met its burden and that its failure to pay tax or timely remit tax was due to reasonable cause and not due to negligence.

FINDING

Taxpayer's protest on the imposition of the negligence penalty is respectfully denied.

SUMMARY

For the reasons discussed above, on Issue I, Taxpayer's protest of the imposition of use tax is sustained in part and denied in part. Taxpayer's protest of Part A and Part C is sustained. However, Taxpayer's protest of Part B is respectfully denied. On Issue II, Taxpayer's protest on the imposition of the negligence penalty is also respectfully denied. The Department will recalculate Taxpayer's liability in a supplemental audit review.

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