DEPARTMENT OF STATE REVENUE

04-20091023.SLOF

Supplemental Letter of Findings: 04-20091023
Sales and Use Tax
For Tax Years 2006 and 2007

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ISSUES

I. Sales and Use Tax – Exemptions.

Authority: IC § 6-2.5-1-21; IC § 6-2.5-5-9; IC § 6-8.1-5-1; 45 IAC 2.2-4-2; 45 IAC 2.2-4-27; 45 IAC 2.2-5-8; 45 IAC 2.2-5-11; 45 IAC 2.2-5-12; 45 IAC 2.2-5-16; Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Department of Revenue v. U. S. Steel Corp., 425 N.E.2d 659 (Ind. Ct. App., 1981); Indiana Dept. of State Revenue v. Harrison Steel Castings Co., 402 N.E.2d 1276 (Ind. Ct. App., 1980). Sales Tax Information Bulletin 2 (May 2002); Sales Tax Information Bulletin 8 (May 2002).

Taxpayer protests the assessment of tax on purchases of tangible personal property.

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 components for various industries. The Indiana Department of Revenue ("Department") conducted a Sales/Use tax audit for tax years 2006 and 2007. Due to the volume of Taxpayer's records, the Department and Taxpayer agreed to use a sample selected from Taxpayer's records and a projection method to perform the audit. Taxpayer, however, did not agree with the outcome of the projection. On the grounds that the projection result was the best information available at the time of the audit, the Department proceeded to assess Taxpayer use tax on the purchases where Taxpayer had not paid sales tax nor self-assessed and remitted use tax to the Department.

Taxpayer protested the imposition of use tax on some of the items arguing the transactions were exempt. Taxpayer also protested the imposition of the ten percent negligence penalty. An administrative hearing was held and Letter of Findings 04-20091023 ("Letter of Findings") was issued on February 9, 2011 sustaining Taxpayer in part and denying Taxpayer in part. Specifically, the Letter of Findings found Taxpayer was entitled to the manufacturing exemption for its purchases of the safety glasses, earplugs, and seven (7) wrapping materials. The Letter of Findings, however, found that the remainder of Taxpayer's purchases, was subject to sales/use tax. Additionally, Taxpayer's protest of the negligence penalty was denied. Subsequent to the issuance of the Letter of Findings, Taxpayer requested and was granted rehearing. A rehearing was conducted and this Supplemental Letter of Findings ensues. Additional facts will be provided as needed.

I. Sales and Use Tax – Exemptions.

DISCUSSION

The Department's audit assessed Taxpayer use tax on purchases of tangible personal property. Taxpayer claimed that it was entitled to the manufacturing exemptions on several purchases of tangible personal property. Taxpayer also claimed that payments for services rendered were not subject to sales and/or use tax.

On rehearing Taxpayer continues to argue that the following items are exempt from sales/use tax because they qualify for the manufacturing exemption: (1) quality control testing and inspection equipment, (2) conveyor systems and chutes, (3) forklift trucks, (4) emergency shut-off switches and safety gloves, (5) machinery replacement parts and supplies, and (6) non-returnable packaging and wrapping materials.

Taxpayer also continues to argue that certain of its payments were for services and therefore not subject to sales/use tax: (1) employee background check services, (2) plant maintenance services, (3) data storage services, and (4) equipment maintenance.

Lastly, Taxpayer continues to protest the negligence penalty.

Taxpayer submitted additional documentation in support of its request for rehearing. The additional documentation consisted of a DVD depicting the protested items in use at Taxpayer's manufacturing facility, as well as additional documentation that will be discussed where relevant.

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).

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 Revenue v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). The taxpayer claiming exemption has the burden of showing the terms of the exemption

statute are met. General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991) aff'd 599 N.E.2d 588 (Ind. 1992) (Internal citations omitted). Additionally "[e]xemption statutes are strictly construed because an exemption releases property from the obligation of bearing its fair share of the cost of government." Id.

This Supplemental Letter of Findings incorporates the statement of the law presented in the related Letter of Findings, and makes the following findings:

A. Manufacturing Exemptions.

1. Quality Control Testing and Inspection Equipment.

Taxpayer claims that it was entitled to the manufacturing exemption on its purchases of "gauges, micrometers and other types of tools and equipment used to test and inspect manufactured parts produced for sale" pursuant to 45 IAC 2.2-5-8(i) which provides that "[m]achinery, tools, and equipment used to test and inspect the product as part of the production process are exempt." During the rehearing process Taxpayer demonstrated that it uses these items to test work-in-process to assure that they meet quality control standards. For example, a holographic micrometer measures the thickness of component material as well as spacing between holes on the items to make sure they comport with specifications.

Taxpayer has provided sufficient documentation to support its protest that these items are not subject to sales/use tax.

2. Conveyor Systems and Chutes.

Taxpayer claimed that, pursuant to 45 IAC 2.2-5-8(c), example 1, it was entitled to the manufacturing exemption on its purchases of "conveyor systems, chutes and repair parts used to move parts from one work station to another." Taxpayer maintains that "off-fall" (scrap material) that results from its production process and which is moved via conveyers and chutes to hoppers where it is stored and eventually transported to shipping is itself a finished product. In its request for rehearing, dated March 4, 2011, Taxpayer reiterates that it makes two types of products for sale, the scrap being one of them. Therefore, Taxpayer argues, the conveyors and chutes used to move the scrap should be exempt because they are directly used in the direct production of scrap.

45 IAC 2.2-5-8(c), in pertinent part, states:

> The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are **directly used in the production process; i.e., they have an immediate effect on the article being produced. 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.** (**Emphasis added**).
>
> --EXAMPLES--
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> (1) Aluminum pistons are produced in a manufacturing process that begins, after the removal of raw aluminum from storage inside the plant, with the melting of the raw aluminum and the production of castings in the foundry; continues with the machining of the casting and the plating and surface treatment of the piston; and ends prior to the transportation of the completed pistons to a storage area for subsequent shipment to customers. Because of the functional interrelationship of the various steps and the flow of the work-in-process, the total production process, comprised of such activities, is integrated.

In addition to the DVD that depicted the process Taxpayer describes, Taxpayer also presented sample customer quotes that show that Taxpayer gave some of its customers "scrap credits" as reduction in the price quoted to their customers by Taxpayer. Taxpayer also showed that in an industry with very small margins, a significant percentage of its small profit margin comes from selling "off-fall."

While Taxpayer may sell the scrap, it is not a "product" manufactured by Taxpayer. The scrap is a by-product of Taxpayer's manufacturing process that Taxpayer sells in secondary markets– however, the scrap is not an item that is manufactured by the transformation of component raw materials into a distinct product. Therefore, in this instance, the conveyor systems and chutes that are used to transport the scrap do not qualify for exemption.

Since Taxpayer did not pay sales tax for these items at the time of the purchase, use tax was properly imposed.

3. Forklifts.

The Department's audit determined that one of its forklifts used in the "Hold Department" was not exempt and assessed use tax accordingly. Taxpayer claimed that it used the forklift one hundred (100) percent in moving semi-finished goods in and out of the Hold Department for further processing. Referring to 45 IAC 2.2-5-8(f)(3), Taxpayer claimed that it was entitled to the manufacturing exemption for the use of that forklift in the "Hold Department." Thus, the issue here is whether the particular forklift cited was within or without Taxpayer's production process. Taxpayer is correct that if the specific forklift was used exclusively for transporting work-in-process to and from the Hold Department, it would be fully exempt. Taxpayer is reminded, however, that the Department's assessment is presumed to be correct, and exemption statutes are applied narrowly. The Department's audit contains a work-paper that summarizes the use of the forklifts as observed by the Department's auditor. The Department's auditor charted the percentage of exempt use for some of the forklifts and assigned an overall percentage of exempt use for the forklifts at issue in the audit. While Taxpayer presented

testimonial evidence at hearing and subsequently presented a DVD that showed a forklift being used to transport work-in-process, the Taxpayer did not sufficiently tie-in to the specific forklifts mentioned in the audit. The presumption is that the Department's audit already incorporated exempt use into its work-paper because the audit's narrative so describes.

The Department's auditor visited Taxpayer's manufacturing facility, toured the production process, heard an explanation of that process directly from Taxpayer's personnel, and witnessed first-hand the manner in which the forklift was used and subsequently presented in the Audit Summary a calculation of use that takes into account exempt and non-exempt use of the forklifts. The documentation Taxpayer has provided at hearing and rehearing did not tie-in to the audit's presentation of information and therefore did not overcome Taxpayer's burden to show exempt use.

Since Taxpayer did not pay sales tax at the time of the purchase, use tax was properly imposed on the forklift repair parts and fuel.

4. Safety Equipment and Apparel.

At hearing Taxpayer claimed that it was entitled to the manufacturing exemption on its purchases of emergency shut-off switches, gloves, glasses, ear plugs, and shields because those items were used to protect its employees' safety pursuant to 45 IAC 2.2-5-8(c), example (2)(F). The Letter of Findings sustained Taxpayer's protest of the purchases of safety glasses and ear plugs, but denied the protest of the shut-off switches and gloves. On rehearing Taxpayer continues to protest that the shut-off switches and gloves are exempt.

45 IAC 2.2-5-8(c) states:

> The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. 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.
>
> --EXAMPLES--
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> ...
>
> (2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product, is not determinative.
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> ...
>
> (F) **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. (**Emphasis added**).

In Department of Revenue v. U. S. Steel Corp., 425 N.E.2d 659 (Ind. Ct. App. 1981), the appellate court affirmed the trial court's findings, in favor of the taxpayer, U.S. Steel Corp., that it was entitled to the manufacturing exemption concerning its purchases of personal protective equipment, including, but not limited to, prescription safety eyeglasses, protective mittens, hardhats, goggles, masks, hoods, jackets and aprons. The U.S. Steel court refined the application of the "double direct standard" illustrated in Indiana Dep't of State Revenue v. Harrison Steel Casting, 402 N.E.2d 1276 (Ind. Ct. App., 1980) and focused on "whether the safety equipment is an integral part of manufacturing and operates directly on the product during production."

Acknowledging that the "U.S. Steel's safety equipment was one of the tools used by workers to accomplish the job," The U.S. Steel court concluded that:

> Since steel can be made only because shielded workers deal directly with the raw materials of the product, the shields not only protect the worker but are a part of manufacturing which operates directly on the product during production.
>
> U.S. Steel, 425 N.E.2d at 664.

As 45 IAC 2.2-5-8(g) explains, however, "[t]he 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." (Internal quotation marks omitted).

In U.S. Steel, but for the shields, the workers would not have been able to directly handle the materials used in the production process. The "emergency shut-off switches" are not directly involved in the production process. Even though their existence provides the assurance of a safer operating environment, nonetheless, the shut-off switches are not like the shields in U.S. Steel discussed above. They are not directly used by workers in the direct manufacturing process.

As for Taxpayer's purchases of gloves, on rehearing Taxpayer met its burden to demonstrate that the gloves were directly used by its employees in the direct manufacturing process to protect themselves from injury.

Therefore, Taxpayer is not entitled to the manufacturing exemption on its purchases of emergency shut-off switches, but is entitled to the manufacturing exemption on its purchases of gloves.

5. Machinery and Equipment Repair and Replacement Parts and Supplies.

Taxpayer claimed that it was entitled to the manufacturing exemptions on purchases of various repair and replacement parts to production machinery and equipment, and production supplies that were consumed in

production. The original Letter of Findings presented the positions taken by the Department and Taxpayer. Specifically, Taxpayer maintains that the manufacturing exemptions were applicable concerning its purchases for the following items:

• [E]lectrical repair parts for production machinery and equipment, cut-off saws to cut and etch parts, drill bits, grinders, sanders, sandpaper, brushes, deburring supplies used for deburring and finishing operations, and a label maker used to produce labels affixed to specify parts and sub-assemblies.

• [D]rills, drill bits, taps, milling equipment, grinding equipment, and other supplies used in development and production of tools and equipment.

• [E]quipment and supplies such as mineral spirits and detergents used to clean parts during the production process, indicating lights for production equipment, clamp sets for holding parts, servo pins used in machines, air tools and hoses used in assembly and production, Freon used to repair a chiller used for production, and other various parts and supplies used and consumed directly in the integrated production process.

As discussed above, manufacturing exemptions only apply to the items which are directly used in direct production and must have the immediate impact on the tangible personal property being produced. The Department's audit noted, in relevant part, as follows:

• The purchase of items that are related to the manufacturing process but do not have a direct impact on the item being produced are not included in the manufacturing exemptions....

• Cleaning equipment and solutions used to maintain tools and other equipment are not included in the manufacturing exemption for consumables. In the sample mineral spirits were purchased exempt from tax; at one point the mineral spirits were used to dilute the oil used in cooling the parts during the production process. As discussed with an operation manager the mineral spirits are no longer used for this purpose, they are only used as a cleaning solution in the tool room. Some invoices for parts cleaners were exempted at 50 [percent] since they were used to clean manufactured parts prior to packaging and to clean equipment. The cleaning of parts prior to packaging is an exempt activity and the cleaning of the equipment is not exempt as it is a maintenance function. The cleaners that are used for routine maintenance of the equipment are not exempt....

• The material portion of a repair to tangible personal property or to real property is subject to use tax. Items such as rip rap, Freon for an AC repair, paint and concrete patch kits were used by the taxpayer for maintaining the facility and not in direct manufacturing.

On rehearing, Taxpayer did not present additional information that describes the use of these items with specific equipment that would be subject to the manufacturing exemption. When the audit makes certain determinations that a taxpayer protests, it is the taxpayer's burden to show how the contested items are used in exempt fashion. Taxpayer has not met its burden to show how these contested items are exempt.

Taxpayer's protest of the imposition of use tax on these items is respectfully denied.

6. Non-returnable Packaging and Wrapping Materials.

Taxpayer claimed that it purchased "doubled sided film tape" exempt. The Letter of Findings analyzed the use of the tape under the "non-returnable packaging and wrapping materials" exemption (IC § 6-2.5-5-9(d)) and denied Taxpayer's protest of this item. On rehearing, Taxpayer stated that it gave incorrect information at hearing and was now able to properly support its claim for exemption of the "double sided film tape."

Taxpayer clarified the documentation it presented at hearing and presented additional documentation at rehearing that demonstrated how the "doubled sided film tape" was used in its production process to adhere insulation to component parts of the final products. The tape is thus consumed directly in the direct production process and is therefore exempt.

The "double sided film tape" is therefore not subject to sales/use tax.

B. Services.

The Department's audit assessed use tax on several transactions, which Taxpayer claimed were services. Taxpayer further maintained that its payments for services rendered were not subject to sales/use tax pursuant to 45 IAC 2.2-4-2(a).

45 IAC 2.2-4-2 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.

(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.

Notably, only when the four requirements mentioned above are fulfilled, is a taxpayer entitled to the exemption pursuant to 45 IAC 2.2-4-2(a).

Believing that the vendors provided services, Taxpayer directed the Department to the following vendors:

1. Payments for Reports of Employee Background Checks.

The Department's audit assessed use tax on Taxpayer's payments to a vendor ("Vendor 1"), an investigative consumer reporting agency, for employee background checks. Taxpayer claimed that Vendor 1 provides an investigative service, and that, as a service, the payments were not subject to sales/use tax.

To support its protest, Taxpayer submitted a letter from Vendor 1 stating, in relevant part, that:

The labor cost to perform the service is greater than 90 [percent] of the cost to print the report. Our business is a professional, service business. [Vendor 1] is not required to pay sales tax on software or access. Our work is done by our in-house staff. [Vendor 1] pays sales tax on all equipment, supplies and materials used in the performance of the service.

Taxpayer also provided a contract, invoices, and sample reports to demonstrate that it was purchasing non-taxable services.

Sales Tax Information Bulletin 8 (May 2002), 25 Ind. Reg. 3934, in relevant part, states:

F. Sale of Miscellaneous Data:

The sale of statistical reports, graphs, diagrams or any other information produced or complied by a computer and sold or reproduced for sale in substantially the same form as it is so produced is considered to be the sale of tangible personal property unless the information from which such reports was compiled was furnished by the same person to whom the finished report is sold.

The charge for reports compiled by a computer exclusively from data furnished by the same person for whom the data is prepared is considered to be for a service and is not subject to sales or use tax unless it is part of a unitary transaction which is subject to sales or use tax.

The sample reports Taxpayer provided contained information such as (1) Employment verification, (2) Reference verification, (3) Education verification, (4) Criminal/Civil records search, (5) Driving verification, (6) Drug testing, (7) Worker's compensation claims, and (8) Credit information.

The original Letter of Findings found that Vendor 1:

[C]ompiled the information, in report formats, and sold the reports "in substantially the same form as [they are] so produced." Thus, Taxpayer did not contract with the vendor to perform and provide a service, i.e. collecting specific and customized information. Instead, Taxpayer purchased the completed products, after the vendor compiled and furnished standard information in the standard report formats. Pursuant to Sales Tax Information Bulletin 8, the reports of employees' background check are tangible personal property and, therefore, taxable.

On rehearing Taxpayer has demonstrated to the contrary that the information provided by Vendor 1 was in large part customized, non-computerized information resulting from individual investigations. Indeed, some of the categories of information included in the final report do represent information "produced or complied by a computer and sold or reproduced for sale in substantially the same form as it is so produced." For example, the credit information – which, had it been a stand-alone report, would have been subject to tax. However, in this instance, a significant portion of the report also contains information that was not produced or compiled by a computer, but rather results from performing hands-on background checks. For example, employment verification, verification of personal and business references, education verification, which entailed efforts other than downloading and compiling computerized data. Therefore, the taxability of these investigation reports falls within 45 IAC 2.2-4-2 quoted above.

Taxpayer's protest of these items is sustained on rehearing.

2. Payments for Plant Maintenance Fees.

The Department's audit assessed use tax on Taxpayer's payments for monthly plant maintenance fees. Taxpayer maintained that the payments were for plant maintenance services provided by a flower shop ("Vendor 2"). Thus, Taxpayer maintained that, as a service, the charges were not subject to sales/use tax.

To support its protest, Taxpayer submitted a letter from Vendor 2 stating, in relevant part, that:

We provided plant maintenance on plants in the office area and charged a weekly labor Charge of $20.00 and billed monthly a total of $80.00. The plants were sold to [Taxpayer] originally but there was no charge

included for future maintenance of the plants.

It should be noted that Taxpayer's grounds are serviced by a grounds maintenance contract different from Vendor 2. In this instance Vendor 2 mostly watered plants. At the hearing, however, Taxpayer indicated that Vendor 2 also included applying fertilizer, the latter being tangible personal property. Taxpayer did not provide any documentation demonstrating that all the four requirements outlined in 45 IAC 2.2-4-2(a) were met. Since Vendor 2 did not separate the charge of the sale of tangible personal property from the charge of the plant maintenance service or document that tangible personal property was no more than ten percent of the total charge, this is a unitary retail transaction subject to Indiana sales/use tax.

Since Taxpayer did not pay sales tax at the time of the purchases, use tax is properly imposed.

3. Payment for On-line Hosting System.

The Department's audit assessed use tax on Taxpayer's payments for online hardware/software hosting and maintenance provided by Vendor 3 for those years. Taxpayer only protested the assessment concerning the "Hosting Fee."

Taxpayer asserted that it paid a monthly service fee for web-hosting and storage. Taxpayer further explained that it "uses the on-line hosting service to store its data related to engineering, sales, raw materials, inventory, production tracking, costing, shipping, purchasing, human resources, and accounting." Thus, Taxpayer maintained that "[t]he monthly fee provides access to the server via Internet access and provides the applications to the taxpayer, including all server-side hardware, databases, system infrastructure, server upgrades, backups, security, and system maintenance."

The original Letter of Findings cited to 45 IAC 2.2-4-27 and IC § 6-2.5-1-21 and concluded that Taxpayer was renting space on Vendor 3's servers. Taxpayer continues to contend that it is being provided a web-hosting service where Vendor 3 maintains physical and operational control over any tangible personal property involved and is responsible for maintaining the Taxpayer's data.

However, as Taxpayer argues on rehearing, Vendor 3 and its servers are located outside of Indiana and therefore any rental payments cannot be subject to Indiana sales and use tax. Taxpayer is correct. Taxpayer makes other primary arguments in protest of this issue which this Supplemental Letter of Findings does not address.

Taxpayer's protest of this issue is sustained on rehearing.

4. Payment for Equipment Maintenance Agreements.

Taxpayer stated that it contracted with three (3) vendors ("Vendor 4," "Vendor 5," and "Vendor 6") to provide periodic inspections, cleaning, and preventive maintenance for the copiers in its offices. Taxpayer further asserted that those maintenance and service agreements had no certainty of transfer of tangible personal property. Thus, Taxpayer maintained that its vendors provided services, which were not subject to Indiana sales/use tax.

The prior version of Sales Tax Information Bulletin 2 stated as follows:

Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax. Any parts or tangible personal property supplied pursuant to this type of agreement are subject to use tax. Sales Tax Information Bulletin 2 (May 2002), 25 Ind. Reg. 3595. (Emphasis added).

However, the current version of Sales Tax Information Bulletin 2 states 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. Sales Tax Information Bulletin 2 (December 2006) (20100804 Ind. Reg. 045100497NRA), 20100804 Ind. Reg. 045100497NRA, (Effective August 4, 2010) (Emphasis added).

The Department's guidance and interpretation on this issue relevant to the years for which Taxpayer was audited is found in Sales Tax Information Bulletin 2 (May 2002) which states that "Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax." Id. Therefore, Taxpayer was not required to pay sales tax on the warranties/maintenance agreements it purchased prior to August 4, 2010. However, if Taxpayer did not pay sales tax on tangible personal property that was provided during this same period, Taxpayer was required to self-assess use tax on any of the parts or supplies it acquired pursuant to those same agreements.

Upon reviewing Taxpayer's contract with Vendor 4, the contract, in relevant part, stated that "Contract includes: drum, toner, developer parts, labor, travel, cleanings, preventive maintenance." Thus, Vendor 4's agreement demonstrated that tangible personal property, such as drum, toner, and developer parts, will be provided. Taxpayer has demonstrated that it paid sales tax when tangible personal property was conveyed to it under the agreement. Therefore for purposes of this Supplemental Letter of Findings, since Taxpayer was subject to the guidance of the 2002 Information Bulletin and Taxpayer has demonstrated that it paid sales tax when the parts were used, then Taxpayer has met its burden to show that it does not owe use tax on the transactions with Vendor 4.

However, for Vendors 5 and 6, Taxpayer has not demonstrated that it paid sales or use tax on tangible personal property provided pursuant to the maintenance agreements. Thus the maintenance agreements with

Vendors 5 and 6 were subject to sales or use tax.

For future maintenance contract payments, Taxpayer would be subject to Indiana sales and use tax pursuant to Sales Tax Information Bulletin 2 (December 2006, effective August 4, 2010) unless Taxpayer can demonstrate that the contract otherwise falls under 45 IAC 2.2-4-2.

C. Credits for Overpayments of Sales Tax on Selected Purchases.

The original Letter of Findings contained the following:

Taxpayer claimed that, within the selected sample, it erroneously paid sales tax on several purchases of tangible personal property. The Department's audit, however, should have, but failed to give Taxpayer the credits. Specifically, Taxpayer mentioned that, within the selected sample, there were purchases of tangible personal property, including, but not limited to, stretch wrap, steel strapping, safety gloves, glasses, earplugs, repair and replacement parts for welding equipment used in the sub-assembly department, welding rod and wire used in assembly operations, and various repairs to manufacturing machinery, tools and equipment, which the Department did not give Taxpayer the credits for sales tax mistakenly paid to the supplier.

Upon reviewing Taxpayer's documentation, the Department agrees that Taxpayer was entitled to the exemption on its purchases of safety glasses and ear plugs as discussed in Subpart A. 4.

Additionally, Taxpayer's documentation also demonstrated that it was entitled to exemption afforded in IC § 6-2.5-5-9 and 45 IAC 2.2-5-16 for seven (7) purchases.

Stratum	Date	Invoice #	Vendor	Amount
5	04/27/06	xxxxxx-xx	xxxxxx.	xxxxxx
5	09/08/06	xxxxxx-xx	xxxxxx.	xxxxxx
5	03/09/07	xxxxxx-xx	xxxxxx.	xxxxxx
5	05/18/07	xxxxxx-xx	xxxxxx.	xxxxxx
5	08/10/07	xxxxxx-xx	xxxxxx.	xxxxxx
5	10/05/2007	xxxxxx-xx	xxxxxx	xxxxxx
6	07/28/06	xxxxxx-xx	xxxxxx.	xxxxxx

Thus, Taxpayer is entitled to credits for sales tax which it mistakenly paid to its vendors on those seven (7) transactions. The Department will recalculate Taxpayer's tax liability accordingly in a supplemental audit.

The Department, however, is not able to agree that Taxpayer demonstrated that (1) the repair and replacement parts for welding equipment (used in the sub-assembly department), (2) welding rod and wire (used in assembly operations), and (3) various repairs to manufacturing machinery, tools, and equipment were directly used in its manufacturing production. Thus, Taxpayer is not entitled to the manufacturing exemption on those purchases and the sales tax was properly paid.

In short, Taxpayer is entitled to credits for the sales tax, which it erroneously paid to its vendors, on its purchases of the above seven (7) wrapping materials, safety glasses, and ear plugs, because Taxpayer has demonstrated that it was entitled to manufacturing exemption.

In addition to the items sustained in the quoted findings, Taxpayer is sustained on any additional items in the sample on which it had paid sales or use tax and is now found to be exempt in this Supplemental Letter of Findings. Otherwise, Taxpayer's protest of these "credit items" is denied.

FINDING

Taxpayer is sustained in part and denied in part. In addition to the items of protests sustained in the Letter of Findings, Taxpayer is now sustained in the Supplemental Letter of Findings on items discussed in:

A(1); A(4) for the gloves but not the shut-off switch; A(6); B(1); B(3); B(4) for Vendor 4 only; and C on any additional items in the sample that this supplemental now sustains. The remaining items are denied.

II. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayer also protests 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.

Pursuant to discussions on rehearing, Taxpayer has demonstrated reasonable cause for its underpayment of sales and use tax.

FINDING

Taxpayer's protest of the negligence penalty is sustained on rehearing.

SUMMARY

Taxpayer is sustained in part and denied in part. In addition to the items of protest sustained in the Letter of Findings, Taxpayer is now sustained in the Supplemental Letter of Findings on items discussed in: A(1); A(4) for the gloves but not the off-switch; A(6); B(1); B(3); B(4) for Vendor 4 only; and C on any additional items in the sample that this supplemental now sustains. The remaining items are denied.

Taxpayer is sustained on its protest of penalty.

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