

Letter of Findings: 04-20120001
Gross Retail Tax
For the Years 2007 through 2010

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ISSUES

I. Exemption Certificates – Gross Retail Tax.

Authority: IC § 6-8.1-5-1(c); IC § 6-2.5-8-8(a); [45 IAC 2.2-8-12\(c\)](#).

Taxpayer argues that the Department of Revenue's audit failed to review seven different exemption certificates which – if reviewed – would have resulted in the reduction of the sales/use tax assessment.

II. Drop Shipment – Gross Retail Tax.

Authority: IC § 6-2.5-5-8(b); IC § 6-8.1-5-1(c); Sales Tax Information Bulletin 57 (March 1995).

Taxpayer provides documentary information purporting to establish that certain transactions were not subject to sales/use tax based on the rules concerning drop shipments.

III. Software Maintenance Agreement – Gross Retail Tax.

Authority: [45 IAC 2.2-5-8\(c\)](#); [45 IAC 2.2-5-8\(g\)\(6\)](#); Sales Tax Information Bulletin 2 (November 2011); Letter of Findings 04-20050438 (August 11, 2006).

Taxpayer maintains that expenses related to a software maintenance agreement were not subject to sales/use tax.

IV. Calculation Error – Gross Retail Tax.

Authority: IC § 6-2.5-3-5(a); [45 IAC 2.2-3-16](#).

Taxpayer states it is not subject to sales/use tax on certain transactions when the evidence provided establishes that it should be given "credit" for tax paid to a state other than Indiana.

V. Labels – Gross Retail Tax.

Authority: IC § 6-2.5-5-6; IC § 6-8.1-5-1(c); [45 IAC 2.2-5-14\(d\)](#); Indiana Dep't. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974).

Taxpayer argues that it was not subject to sales/use tax on the price paid to purchase labels attached to its products.

VI. Calculation Error – Gross Retail Tax.

Authority: IC § 6-8.1-5-1(c).

Taxpayer points to what it maintains is a calculation error contained on page 22 of the audit report.

STATEMENT OF FACTS

Taxpayer is an Indiana business which manufactures various architectural glass products. The Department of Revenue ("Department") conducted an audit review of Taxpayer's business records. The audit resulted in the assessment of additional sales/use tax. Taxpayer disagreed with the assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Exemption Certificates – Gross Retail Tax.

DISCUSSION

The Department assessed Taxpayer sales/use tax. The assessment was based on a sample of Taxpayer's transactions. According to the audit report, "[S]ales transactions not supported by an exemption certificate or other documentation constitute[d] audit errors." As primary authority for the assessment, the audit cited to [45 IAC 2.2-8-12\(c\)](#) which states:

All retail sales of tangible personal property for delivery in the state of Indiana shall be presumed to be subject to sales or use tax until the contrary is established. The burden of proof is on the buyer and also on the seller unless the seller receives an exemption certificate.

The regulation points out that 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."

Indiana law states:

A person, authorized under subsection (b), who makes a purchase in a transaction which is exempt from the state gross retail and use taxes, may issue an exemption certificate to the seller instead of paying the tax.

The person shall issue the certificate on forms and in the manner prescribed by the department. A seller accepting a proper exemption certificate under this section has no duty to collect or remit the state gross

retail or use tax on that purchase. IC § 6-2.5-8-8(a) (Emphasis added).

Taxpayer has provided copies of seven different exemption certificates which Taxpayer asserts establish that transactions otherwise contained within the sample were exempt from sales/use tax.

Taxpayer is correct; Taxpayer has met its burden of demonstrating that the exemption certificates establish that a number of the transactions contained within the sample were exempt from sales/use tax. The audit should be corrected to remove the relevant transactions.

FINDING

Taxpayer's protest is sustained.

II. Drop Shipment – Gross Retail Tax.

DISCUSSION

Taxpayer disagrees with the inclusion of two transactions with two different vendors on the ground that the transactions with these two vendors represent "drop shipments." As authority for its argument, Taxpayer cites to Sales Tax Information Bulletin 57 (March 1995) in effect at the time the transactions occurred. Specifically, Taxpayer points to the following:

If the purchaser is not required to be registered with the Department, the seller may accept documentation from the purchaser indicating that the purchaser is not required to be registered and that the purchaser is reselling the property being purchased. Such documentation must include the following:

1. Purchaser's name;
2. Purchaser's address
3. Purchaser's federal ID number or Social Security number and home state sales tax registration number if applicable;
4. Description of the articles purchased;
5. Statement indicating that the articles purchased are to be resold and that the purchaser is not required to register as an Indiana retail merchant; and
6. Authorized signature of the purchaser. (Emphasis added).

In effect, Taxpayer necessarily relies on the exemption set out in IC § 6-2.5-5-8(b) which states:

Transactions involving tangible personal property other than a new motor vehicle are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business without changing the form of the property.

Taxpayer has provided documents labeled "Statement of Drop Shipment" meeting the requirements set out in Sales Tax Information Bulletin 57 (March 1995). Therefore, Taxpayer has met its burden under IC § 6-8.1-5-1(c) of establishing that the subject transactions are exempt pursuant to IC § 6-2.5-5-8(b) and that the audit assessment should be adjusted to reflect that determination.

FINDING

Taxpayer's protest is sustained.

III. Software Maintenance Agreement – Gross Retail Tax.

DISCUSSION

Taxpayer argues that it is not subject to sales or use tax on the money it pays for a software maintenance agreement on the ground that the software directly affects the production of its glass products.

Taxpayer paid a company called "Softsolution" for a software maintenance agreement. It should be noted that Taxpayer paid a portion of the total cost for this agreement because the cost is allocated between related businesses found in different states.

The software is used to digitize production drawings and then to use that digitized information to guide the fabrication of Taxpayer's glass products.

As such, the software comes within the ambit of [45 IAC 2.2-5-8\(c\)](#) which states that:

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 personal property.

More specifically applicable to Taxpayer's software is the example found at [45 IAC 2.2-5-8\(g\)\(6\)](#) which states that, "Computers which are interconnected with and control other production machinery or are used to make tapes which control computerized production are exempt from tax."

The issue is whether this particular software maintenance agreement is subject to tax. The Department has held that software maintenance agreements are presumably subject to sales tax.

In the case of software maintenance agreements or optional warranties, the presumption is that tangible personal property in the form of updates or patches will be transferred. Software maintenance agreements and optional warranties are presumed to be subject to sales and use tax. The amount subject to tax includes any subsequent payments made by the purchaser, such as deductibles or other fees. This presumption can be rebutted if the taxpayer can demonstrate that no updates were actually received. Sales Tax Information Bulletin 2 (November 2011), 20111228 Ind. Reg. 045110764NRA. See also Letter of Findings 04-20050438

(August 11, 2006), 20061101 Ind. Reg. 045060474NRA. ("T]he department will construe software maintenance agreements and optional agreements as presumed to be subject to the sales and use tax.")

In the case of this particular software maintenance agreement, it is unnecessary for Taxpayer to rebut the presumption that the vendor supplies "updates and patches" because – given the fact that the software itself is exempt – any updates and patches that would be supplied would also be exempt. Therefore, the software maintenance agreement – because it provides for services and putatively exempt "tangible personal property" – is also exempt.

FINDING

Taxpayer's protest is sustained.

IV. Calculation Error – Gross Retail Tax.

DISCUSSION

Taxpayer maintains that the Department failed to provide a "credit" for sales tax paid to another state. In particular, Taxpayer points to an April 2007 invoice from "Kronos" and a May 2009 invoice from a company call "Psion Teklogix."

Taxpayer necessarily relies on the credit set out in IC § 6-2.5-3-5(a), which provides in pertinent part: "A person is entitled to a credit against the use tax imposed on the use, storage, or consumption of a particular item of tangible personal property equal to the amount, if any, of sales tax, purchase tax, or use tax paid to another state, territory, or possession of the United States for the acquisition of that property." See also [45 IAC 2.2-3-16](#) ("Liability for Indiana use tax shall be reduced by a credit for the amount of any sales, purchase, or use tax paid to any other state....")

The audit is requested to review the two cited invoices and to make whatever credit adjustment it deems appropriate.

FINDING

Taxpayer's protest is sustained.

V. Labels – Gross Retail Tax.

DISCUSSION

Taxpayer argues that it was not subject to sales/use tax on the purchase of product labels and that it should be given a credit for the tax it did pay.

Taxpayer purchased labels from "Arrow Graphics" located in Kentucky. Tax was not paid to Kentucky but Taxpayer self-assessed use tax on the transactions.

Taxpayer necessarily relies on the exemption set out in IC § 6-2.5-5-6 which states in part as follows: Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for incorporation as a material part of other tangible personal property which the purchaser manufactures, assembles, refines, or processes for sale in his business.

[45 IAC 2.2-5-14](#)(d) further explains:

(d) The purchase of tangible personal property which is to be incorporated by the purchaser as a material or an integral part is exempt from tax. "Incorporated as a material or an integral part into tangible personal property for sale by such purchaser" means:

- (1) That the material must be physically incorporated into and become a component of the finished product;
- (2) The material must constitute a material or an integral part of the finished product; and
- (3) The tangible personal property must be produced for sale by the purchaser.

(e) Application of general rule.

- (1) Incorporation into the finished product. The material must be physically incorporated into and become a component part of the finished product.
- (2) Integral or material part. The material must constitute a material or integral part of the finished product.
- (3) The finished product must be produced for sale by the purchaser.

In applying a tax exemption such as that found in IC § 6-2.5-5-6, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dep't. of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). A statute which provides a tax exemption, however is strictly construed against the taxpayer. *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Id.* at 100-101.

In this case, Taxpayer has not met its burden under IC § 6-8.1-5-1(c) of establishing that it is entitled to the exemption. While Taxpayer's labels may be required by its customers and/or an essential component within Taxpayer's distribution process, the labels do not become "material parts" of Taxpayer's products. The labels do not "constitute a material or integral part of the finished product." The labels are not essential to Taxpayer's finished products and do not affect the performance or utility of those finished products.

FINDING

Taxpayer's protest is respectfully denied.

VI. Calculation Error – Gross Retail Tax.

DISCUSSION

Taxpayer argues that the audit report contains a calculation error on page 22. According to Taxpayer, "The recap schedule shows total errors of \$421.20 while the exceptions listing detail shown for October 2009 in the audit (page 10 of the audit report) only shows \$215.30 in errors."

Taxpayer requests that, "[T]he correct amount of errors be carried to the projection calculation page after all previous listed adjustments are also considered."

An administrative hearing is not the proper setting to determine matters best left to the Department's audit division. However, Taxpayer has provided sufficient information pursuant to IC § 6-8.1-5-1(c) necessary to establish that the report should be reviewed and that any adjustment based on Taxpayer's explanation be made.

FINDING

Taxpayer's protest is sustained subject to audit verification.

SUMMARY

Taxpayer's purchases of labels are subject to sales/use tax; in all other respects, Taxpayer's protest is sustained subject to audit verification as specified above.

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