DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 04-20120045
Use Tax
For Tax Years 2008-10

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ISSUE

I. Use Tax–Imposition.

Authority: IC § 6-2.5-1-1; IC § 6-2.5-2-2; IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-4-10; IC § 6-2.5-5-3; IC § 6-8.1-5-1; 45 IAC 2.2-3-4; 45 IAC 2.2-4-2.

Taxpayer protests the imposition of use tax on some transactions.

STATEMENT OF FACTS

Taxpayer is an Indiana commercial printer which generates billing statements and related products for its clients. In the course of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had not paid sales tax on some transactions upon which tax should have been paid during the tax years 2008, 2009, and 2010. Therefore, the Department issued proposed assessments for use tax and interest for those years. Taxpayer protested that some of those purchases were not subject to sales and use tax. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Use Tax–Imposition.

DISCUSSION

Taxpayer protests the imposition of use tax on certain transactions during the tax years 2008, 2009, and 2010. The Department examined Taxpayer's records and used a statistical sample and projection method to determine use tax compliance for ordinary purchases. The Department reviewed capital purchases separately and assessed use tax on a purchase-by-purchase basis. Taxpayer protests that some of the ordinary purchases included as subject to use tax in the Department's projection method were not actually subject to use tax and that the projections need to be recalculated and reapplied. Also, Taxpayer protests that certain capital purchases were not subject to sales or use tax. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

Sales tax is imposed by IC § 6-2.5-2-1, which states:

(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. (Emphasis added).

Use tax is imposed under IC § 6-2.5-3-2(a), which states:

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 2.2-3-4 further explains:

Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

Therefore, when tangible personal property is used, stored, or consumed in Indiana, use tax is due unless sales tax was paid at the time of the transaction. In the instant case, the Department determined that Taxpayer had not paid sales tax on some taxable purchases and so imposed use tax on those purchases. Taxpayer protests that some of those purchases identified as taxable were not subject to sales or use tax.

The first category of transactions under protest consists of three transactions for a 120 KVA UPS umbilical power supply. In the course of the protest and hearing process, Taxpayer was able to supply documentation and analysis which establishes that the equipment provides power solely to production equipment. 45 IAC 2.2-5-8 provides in relevant part:

(a) In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. The exemption provided in this regulation [45 IAC 2.2] extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.

(b) The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of

tangible personal property.

(c) 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–

(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.

(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.

(A) Air compressors used as a power source for exempt tools and machinery in the production process.

(B) An electrical distribution system, including generators, transformers, electrical switchgear, cables inside or outside the plant, and related equipment used to produce and/or supply electricity to exempt manufacturing equipment used in direct production.

(C) A pulverizer for raw materials to be used in an exempt furnace to produce and/or supply energy to manufacturing equipment used in direct production.

(D) Boilers, including related equipment such as pumps, piping systems, etc., which draw water, or produce and transmit steam to operate exempt machinery and equipment used in direct production.

(E) A work bench used in conjunction with a work station or which supports production machinery within the production process.

(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.

(G) An automated scale process which measures quantities of raw aluminum for use in the next production step of the casting process in the foundry.

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(Emphasis added).

Therefore, since Taxpayer has established that the umbilical power supply system equipment is used solely to power exempt production equipment, it is exempt as provided in 45 IAC 2.2-5-8(c). Taxpayer has met the burden imposed by IC § 6-8.1-5-1(c) for this portion of its protest.

The second category under protest consists of a single charge listed under "Capital Asset 1091" in the audit report. The charge is for generator equipment used to supply power to Taxpayer's computer room at Taxpayer's production facility. As part of the protest process, Taxpayer provided additional documentation and analysis which supports its position that the generator was used solely to provide backup power to computers directly used in Taxpayer's production process. As discussed above, 45 IAC 2.2-5-8(c) provides an exemption for such equipment. Taxpayer has met the burden imposed by IC § 6-8.1-5-1(c) for this portion of its protest.

The third category under protest consists of rental of server capacity on a third-party MTA Hurricane Server. Taxpayer states that this server is the device upon which Taxpayer's programs generate the billing statements for Taxpayer's clients. The first relevant statute is IC § 6-2.5-4-10(a), which states:

A person, other than a public utility, is a retail merchant making a retail transaction when he rents or leases tangible personal property to another person other than for subrent or sublease.

Next, IC § 6-2.5-5-3(b) provides:

Except as provided in subsection (c), 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.

Taxpayer has provided sufficient documentation and analysis to establish that this server is used solely in its production process. Therefore, the rental of tangible personal property in the form of server capacity is a retail transaction as provided by IC § 6-2.5-4-10(a). Since that transaction involves manufacturing equipment which Taxpayer directly uses to directly process the billing statements for its clients, it is exempt from sales and use tax as provided by IC § 6-2.5-5-3(b).

The fourth category under protest consists of a Storage Area Network ("SAN") server which Taxpayer states is necessary to hold all of the data which it uses to directly produce the billing statements for its customers. Taxpayer explains that none of its other servers have hard drives and so they rely on the SAN to hold all of the operating systems and data directly used in its production process. The data is fed back and forth to the various production servers and since the newly available information shows that the SAN is used exclusively for

production purposes, the SAN is exempt as provided by 45 IAC 2.2-5-8.

The fifth category under protest consists of payments to the vendor "Xiotech" for service to the SAN server discussed above. A review of the documentation supplied during the protest process shows that the service agreement covers service and parts for the SAN server. The Department based its determination that the service contract was taxable on the lack of documentation available during the audit. 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.

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(Emphasis added).

It has now been shown that the service agreement covered service and the provision of repair parts to a piece of manufacturing equipment which is directly used in the direct production of Taxpayer's product. As provided by 45 IAC 2.2-5-8(h)(2), those parts are exempt from tax. Since the service agreement calls for the provision of service, which is exempt, and for the provision of exempt parts, as provided by 45 IAC 2.2-5-8(h)(2), there is no part of the service agreement which is subject to sales or use tax. Taxpayer has met the burden imposed by IC § 6-8.1-5-1(c).

The sixth category under protest consists of payments to another service vendor. Taxpayer states that the payments were for services only and that the transactions were therefore not subject to sales and use tax. The Department based its determination that the transactions were subject to sales and use tax on the basis that the vendor's service included the provision of tangible personal property in the course of providing data storage services. Taxpayer protests that the data storage is collected and stored throughout the production process. The relevant regulation is 45 IAC 2.2-4-2, which 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.

(Emphasis added).

Therefore, the value of tangible personal property transferred in the provision of a service must not exceed ten percent of the service charge in order for the exemption provided by 45 IAC 2.2-4-2 to apply. After review of the supporting documentation, Taxpayer has not established that all four requirements of 45 IAC 2.2-4-2(a) are met and that the data storage service is not properly subject to sales and use tax. Taxpayer has not met the burden imposed under IC § 6-8.1-5-1(c).

In conclusion, Taxpayer has met the burden imposed under IC § 6-8.1-5-1(c) in regards to umbilical power supply system equipment, generator equipment, the rental of an MTA Hurricane Server, the SAN server, and the maintenance agreement with Xiotech. Taxpayer has not met the burden imposed under IC § 6-8.1-5-1(c) in regards to the service agreement with the data storage services vendor. A supplemental audit will use these findings to adjust the use tax calculations for capital assets and the use tax compliance calculations determined via the sample and projection method.

FINDING

Taxpayer is sustained in part and denied in part as described above.

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