DEPARTMENT OF STATE REVENUE

04-20170259.LOF

Letter of Findings: 04-20170259
Gross Retail Tax
For 2013-2014

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Hospital provided sufficient evidence to show that purchases for attached fitness center were exempt from sales tax. Hospital also provided sufficient documentation and reasonable cause to warrant a waiver of negligence penalty.

ISSUES

I. Sales Tax - Not-For-Profit Organization.

Authority: IC § 6-2.5-5-25; IC § 6-8.1-5-1; *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); 45 IAC 2.2-5-55; I.R.S. Priv. Ltr. Rul. 200051049 (December 22, 2000).

Taxpayer argues that its purchases for a fitness center were exempt from sales tax.

II. Tax Administration–Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of the negligence penalty.

STATEMENT OF FACTS

Taxpayer is a not-for-profit hospital operating in Indiana. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit for tax years 2013 and 2014 and, as a result issued a proposed assessment for sales tax, use tax, penalty, and interest. Taxpayer timely protested the assessment. An administrative hearing was held and this decision ensues. Additional facts will be supplied as needed.

I. Sales Tax - Not-For-Profit Organization.

DISCUSSION

As a threshold issue is whether Taxpayer's fitness center is exempt as part of Taxpayer's not-for-profit status. 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 Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to an agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Thus all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

The Department assessed sales tax on several purchases by Taxpayer for its fitness center. The Department determined that the items assessed do not further Taxpayer's not-for-profit purpose and therefore are not exempt

from sales or use tax. Taxpayer asserts that it is a not-for-profit organization and that its purchases qualify for exemption under IC § 6-2.5-5-25.

IC § 6-2.5-5-25 states:

(a) Transactions involving tangible personal property or service are exempt from the state gross retail tax, if the person acquiring the property or service:
(1) is an organization described in section 21(b)(1) of this chapter;
(2) *primarily uses the property or service to carry on or to raise money to carry on its not-for-profit purpose*; and
(3) *is not an organization operated predominantly for social purposes*.

(b)Transactions occurring after December 31, 1976, and involving tangible personal property or service are exempt from the state gross retail tax, if the person acquiring the property or service:
(1) is a fraternity, sorority, or student cooperative housing organization described in section 21(b)(1)(A) of this chapter; and
(2) uses the property or service to carry on its ordinary and usual activities and operations as a fraternity, sorority, or student cooperative housing organization.

(*Emphasis added*).

45 IAC 2.2-5-55 states:

(a) Sales to a qualified not-for-profit organization of tangible personal property or services used primarily in carrying out the not-for-profit purpose of the organization or in raising money for carrying on such purposes are exempt from the gross retail tax.
(b) In order to qualify for the sales tax exemption on purchases, as a qualified not-for-profit organization, the following conditions must prevail:
(1) The organization must be qualified by being named or described in IC 6-2.1-3-20, IC 6-2.1-3-21, or IC 6-2.1-3-22 which deals with fraternities, sororities, student cooperative housing organizations, etc. This includes not-for-profit organizations organized and operated exclusively for one (1) or more of the following purposes:
(A) Religious.
(B) Charitable.
(C) Scientific.
(D) Fraternal.
(E) Educational.
(F) Literary.
(G) Civic.
(2)Also included are the following specifically named not-for-profit organizations:
(A) Labor unions.
(B) Licensed hospitals.
(C) Churches.
(D) Monasteries.
(E) Convents.
(F) Cemetery associations.
(G) Public schools.
(H) Parochial schools.
(I) Pension trust.
(J) Business leagues.
(3) The organization is not operated predominantly for social purposes. The article purchased must be used for the same purpose as that for which the organization is being exempted. Purchases for the private benefit of any member of the organization or for any other individual, such as meals or lodging, are not eligible for exemption. Purchases used for social purposes are never exempt.
(4) The fact that an organization is being exempted by the federal government or by the state of Indiana for income tax purposes does not necessarily mean that a purchase made by the not-for-profit organization is exempt.
(c) Purchases of tangible personal property by a qualified not-for-profit organization used to raise funds to further the exempt purpose of the organization are exempt even if the resale of such property is not subject to tax. The following are examples:
(1) A qualified religious organization purchases envelopes which are distributed to members for use in

making weekly contributions to the church. The purchase of the envelopes by the church is exempt because the envelopes will be used to raise funds for the qualified not-for-profit organization.

(2)A qualified hospital purchases advertising posters to be used in a fundraising drive for the hospital. The purchase of the posters is exempt from the state gross retail tax because the posters will be used to raise funds for the qualified not-for-profit organization.

(d) *Purchases of tangible personal property or services used primarily in carrying out the not-for-profit purpose of the qualified organization are exempt from tax. This exemption will not apply if such property is primarily used for a purpose other than the not[-]for-profit purpose of the organization. As used in this section, "primarily used in carrying out the not-for-profit purpose" means that the item or service is used more than fifty percent (50[percent]) of the time to further the organization's not-for-profit purpose.* The following are examples:

(1) A religious organization acquired building materials to construct a new church. The purchase of such materials by the church is exempt since the new church will further the not-for-profit purpose of the organization. The fact that the church basement will occasionally be used for social events does not subject the purchase of construction materials to tax.

(2) A church sponsors a ski club for its teenage membership. The ski club purchases skis, boots, and poles to be used by the church ski club members on ski trips. These purchases are taxable because the skis, boots, and poles are used primarily to further the social purposes of the ski group and not the exempt purpose of the church.

(3) A fraternal lodge operated a golf club, a bowling alley, and a lounge where liquor is served. Purchases of property used in these facilities are taxable because the property is used for a purpose other than the not-for-profit fraternal purpose of the lodge. However, the purchase of ceremonial robes for use in fraternal meetings is exempt because the robes are used to further the not-for-profit purpose of the organization.

(4) Sales of meals at medical society meetings are taxable because the meals are provided for the convenience of the organization and its members. Such sales are taxable even when served in conjunction with a meeting which is furthering their not-for-profit purpose.

(e) *A social organization will be deemed to exist for predominantly social purposes if more than fifty percent (50 [percent]) of its expenditures are for, or related to, social activities.* Social activities include the following:

(1) Food and beverage services.
(2) Furnishing of sleeping rooms.
(3) Club rooms.
(4) Lounges.
(5) *Recreational activities.*
(6) Any other social activities.

(*Emphasis added*).

Taxpayer previously requested an IRS Private Letter Ruling ("PLR") regarding whether the fitness center and roller rink are not unrelated business income. The PLR states:

> Section 511(a) of the Code imposes a tax on the unrelated business income of organizations described in section 50l(c).
>
> Section 5l2(a)(l) of the Code defines "unrelated business taxable income" as the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of the trade or business, with certain modifications.
>
> Section 513(a) of the Code defines "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its exempt purpose or function.
>
> Section 513(a)(2) of the Code provides, in part, that the term "unrelated trade or business" does not include any trade or business which is carried on in the case of an organization described in section 501 (c)(3) by the organization primarily for the convenience of its employees.
>
> Section 1.513-1 (d)(2) of the regulations provides, in part, that a trade or business is related to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes; and it is substantially related for purposes of section 513 of the Code only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production

or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes.

Section 514(a)(l) of the Code includes as an item of gross income derived from a trade or business a certain percentage of the income derived from or on account of each debt-financed property.

Section 514(b)(I)(A) of the Code provides, in part, that "debt-financed" property does not include any property substantially all the use of which is substantially related to the exercise or performance by such organization of its charitable or other purpose constituting the basis for its exemption under section 501.
. . .

Rev. Rul. 79-360, 1979-2 C.B. 236, distinguishes the operation of a health club from the operation of a recreational and fitness center on the basis of fees charged to members of the two facilities. An organization described in section 501(c)(3) of the Code, whose purpose was to provide for the welfare of young people, operated a recreational and fitness facility and a separate health club under a two-tiered membership structure that made recreational facilities available to the general public at one rate, and health club facilities available at a higher rate. The Rev. Rul. concluded that the operation of the health club facilities generated unrelated business taxable income under section 513, because its operation did not contribute importantly to the organization's exempt purpose. The operation of the health club was seen to be separate from the organization's general fitness program inasmuch as the commercially comparable annual dues or daily fees were sufficiently high to restrict participation in the health club to a limited segment of the community.

The activities of a fitness center owned by a hospital may promote health under section 501(c)(3) of the Code in certain instances. The rehabilitation of hospital inpatients or outpatients in accordance with treatment plans prescribed by physicians or appropriate hospital personnel furthers the hospital's exempt purpose of serving the healthcare needs of the community. Accordingly, your cardiac rehabilitation program promotes the health of the community within the meaning of Rev. Rul. 69-545, supra, and is substantially related to the furtherance of your exempt purposes under section 501(c)(3). Also, use of the fitness center by your employees would fall under the "convenience" exception of section 5l3(a)(2).

As for use of the facility by the general public, a fitness center can further a charitable purpose if it is available to a significant segment of the community. The operation of such a fitness center is related to the charitable purpose of providing community recreational facilities only if the fees charged are affordable to the community served. In this regard, with the assistance of a professional consultant you have surveyed your membership to determine your members' income levels and compared the results of this survey to income data for the general community. The survey data you submitted shows that the fitness center is available to, and the fees charged are affordable by, an economic cross-section of the community. Therefore, for purposes of section 5l3(a) of the Code, amounts derived from your regular membership category constitute income from an activity that is substantially related to your exempt purpose.

The information submitted concerning the operation of the roller rink clearly indicates that the fee structure makes this facility affordable for the community, and, therefore, for purposes of section 513(a) of the Code its operation is substantially related to your exempt purpose.

Since the facility is "debt-financed" within the meaning of section 514 of the Code, the leasing of space in the facility must be substantially related to your exempt purpose for the fees generated to be excluded from the unrelated business income tax. The facts you submitted indicate that the leasing of space to a chiropractor and physical therapist is substantially related to your exempt purpose, and the fees generated are therefore not subject to the unrelated business income tax.

I.R.S. Priv. Ltr. Rul. 200051049 (December 22, 2000).

Since Indiana's not-for-profit rules mirror those of the Internal Revenue Code, and since Taxpayer received a binding interpretation of the exact issue in question here from the IRS, absent other findings the Department, in this case, will not deviate from the IRS findings. The IRS has ruled that Taxpayer's fitness center is not considered an unrelated business and is therefore exempt. Specifically the IRS based its ruling on accepting Taxpayer's membership survey and other supporting documents to show that the fitness center furthered Taxpayer's charitable purpose. Therefore, for this particular instance, based on Taxpayer's I.R.S. Priv. Ltr. Rul. 200051049 (December 22, 2000), Taxpayer has met its burden under IC § 6-8.1-5-1(c) to show that the protested fitness center expenses are exempt from sales tax.

FINDING

Taxpayer's protest is sustained for the tangible personal property at issue.

II. Tax Administration–Penalty.

Taxpayer requested that the Department abate the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1(a), the Department may assess a 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 when "the taxpayer affirmatively establishes that the failure . . . was due to reasonable cause and not due to negligence." 45 IAC 15-11-2(c). 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." *Id*. The Department is mindful that "[r]easonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case." *Id*.

In this instance, Taxpayer has demonstrated that its actions were reasonable as described in 45 IAC 15-11-2(c). Thus, Taxpayer's request for penalty abatement is granted.

FINDING

Taxpayer's protest of the negligence penalty is sustained.

SUMMARY

In Issue I, Taxpayer's protest is sustained. Taxpayer is also sustained regarding Issue II.

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