DEPARTMENT OF STATE REVENUE

04-20191121.LOF

Letter of Findings: 04-20191121
Gross Retail and Use Tax
For the Years 2016 and 2017

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Out-of-State Medical Services Provider established that it was not required to pay use tax on payments for exempt services but did not establish that separately stated purchases of construction materials - supplied pursuant to time and material contracts - were also exempt. Although "required by practical necessity," the Department did not agree that a device used to monitor Medical Services Provider's printing process was exempt "production" equipment.

ISSUES

I. Gross Retail and Use Tax - Exempt Transactions.

Authority: IC § 6-2.5-2-1(a); IC § 6-2.5-3-2(a); IC § 6-2.5-3-2(e); IC § 6-2.5-4-9; IC § IC § 6-2.5-5-3(b); IC § 6-2.5-13-1(d)(1); IC § 6-2.5-13-1(d)(2); IC § 6-8.1-5-1(c); *Indiana Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Rhoade v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); 45 IAC 2.2-4-2; 45 IAC 2.2-4-2(a); 45 IAC 2.2-5-8; Sales Tax Information Bulletin 60 (November 2017, Retroactive eff. Jan 1, 2010).

Taxpayer states it was not required to pay sales tax or remit use tax on exempt transactions.

II. Gross Retail and Use Tax - Negligence Penalty.

Authority: IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(2); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer argues that the Department should exercise its authority to abate the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an out-of-state company, with locations in Indiana, in the business of providing services to medical care providers. Taxpayer sells its customers business forms, document management services, and various imaging and packaging services.

The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer's business records, tax returns, and transaction records. The Department found that Taxpayer should have paid sales tax or self-assessed use tax on various transactions which took place during the years under audit. The audit resulted in the assessment of additional sales/use tax. Taxpayer disagreed with a portion of 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. Gross Retail and Use Tax - Exempt Transactions.

DISCUSSION

Taxpayer argues that it was not required to pay sales tax or self-assess use tax on ten, separate transactions for the reasons outlined below.

A. Service Only Transactions.

Taxpayer states it was not required to pay tax on a series of three transactions on the ground that the transactions were for services only and not for the purchase of tangible personal property.

1. Taxpayer's Burden.

Under IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Moreover, when a taxpayer challenges taxability in a specific instance, the taxpayer is required to provide documentation explaining and supporting its challenge. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). When an agency is charged with enforcing a statute, the jurisprudence defers to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Indiana Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014).

2. Indiana's Gross Retail Tax.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). "When the product is received by the purchaser at a business location of the seller, the sale is sourced to that business location." IC § 6-2.5-13-1(d)(1). "When the product is not received by the purchaser at a business location of the seller, the sale is sourced to the location where receipt by the purchaser . . . occurs . . . ." IC § 6-2.5-13-1(d)(2).

3. Indiana's Complimentary Use Tax.

Indiana also imposes a complementary excise tax called "the use tax" 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." IC § 6-2.5-3-2(a). "Use" means the "exercise of any right or power of ownership over tangible personal property." *Id*.

In effect and practice, the use tax is generally functionally equivalent to the sales tax. See *Rhoade v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002). However, Indiana's use tax - not sales tax - allows an exemption for the "temporary storage" of tangible personal property delivered into Indiana but destined for use outside the state. IC § 6-2.5-3-2(e).

4. Exempt Services.

Taxpayer relies on 45 IAC 2.2-4-2 as authority for its position that these purchases are exempt from sales/use tax.

45 IAC 2.2-4-2 provides as follows:

> (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.

The regulation on which Taxpayer depends, 45 IAC 2.2-4-2, contains a provision exempting the purchase of services from sales and use tax. 45 IAC 2.2-4-2(a) states that, "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." However, "Where, in conjunction with rendering professional services . . . the serviceman also transfers tangible personal property for a consideration, this will constitute a transaction of a retail merchant constituting selling at retail . . . ." *Id.*

After reviewing the information provided, the Department is prepared to agree that Taxpayer has established it was not required to collect taxes on the following three transactions. In these cases, Taxpayer was selling its customers services not subject to sales tax.

- Lincoln National Life Insurance Co., $1,100 Invoice 45366997
- Lincoln National Life Insurance Co., $1,100 Invoice 45522589
- Lincoln National Life Insurance Co., $1,000 Invoice 45687491

B. Improvements to Realty.

Taxpayer hired Kentucky contractors to perform installation and maintenance work at its Indiana locations. The contractors charged Taxpayer for the labor costs and for the material costs on invoices which separately stated those two expenses. The Department assessed use tax on the material charges listed on those invoices.

Taxpayer argues that it is not required to pay sales or use tax on purchases of tangible personal property from Kentucky vendors because the Kentucky vendors were required to pay tax to that state at the time they originally purchased the items. According to Taxpayer, the Department's assessment "would result in double taxation of those materials, and taxation of non-taxable labor."

IC § 6-2.5-4-9 provides in relevant part as follows:

> (a) A person is a retail merchant making a retail transaction when the person sells tangible personal property which:
> (1) is to be added to a structure or facility by the purchaser; and
> (2) after its addition to the structure or facility, would become a part of the real estate on which the structure or facility is located.
>
> (b) A contractor is a retail merchant making a retail transaction when the contractor:
> (1) disposes of tangible personal property; or
> (2) converts tangible personal property into real property;
> under a time and material contract. As such a retail merchant, a contractor described in this subsection shall collect, as an agent of the state, the state gross retail tax on the resale of the construction material and remit the state gross retail tax as provided in this article.

Sales Tax Information Bulletin 60 (November 2017, Retroactive eff. Jan. 1, 2010), 20180131-IR-045180051NRA, explains further:

> Under Indiana law, contractors are retail merchants selling construction material when they (1) dispose of, or (2) convert construction material into real property under a time and material contract. Time and material contracts are contracts in which the cost of construction material and the cost of labor or other charges are stated separately. Because all sales of tangible personal property, including sales of construction material, are taxable, contractors converting construction material into real property under a time and material contract must collect and remit sales tax on the material portion of their contracts.

In this case, Indiana law required that the contractors collect Indiana sales tax on the enumerated sales of tangible personal property sold pursuant to a time and materials construction contracts. Because the contractors failed to do so, the Department's audit was correct in assessing Indiana's complimentary use tax. The fact that a

different but separate tax was imposed on upstream transactions relieves neither the contractors nor Taxpayer of its responsibility.

C. Exempt Production Equipment.

Taxpayer purchased a "Discovery Vision System" (DVS) for use in production of its printed products. The vendor did not charge sales tax and Taxpayer did not self-assess use tax on this purchase. The Department's audit determined that this system was a non-exempt capital asset and imposed use tax. Taxpayer disagreed arguing that the DVS is exempt from sales/use tax because "[i]t is production equipment that is integral to the production process and quality control."

As authority for its conclusion the DVS is exempt, Taxpayer necessarily relies the Indiana's statutory exemption, IC § 6-2.5-5-3(b), which states in part:

> 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.

The Department's regulation, 45 IAC 2.2-5-8, explains that a taxpayer is entitled to purchase machinery, tools, and equipment without payment of the gross retail tax when the equipment is used in the direct production of tangible personal property. 45 IAC 2.2-5-8(a) emphasizes that the exemption is limited to equipment "directly used by the purchaser in direct production." 45 IAC 2.2-5-8(c) specifies that "directly used" means that the equipment has "an immediate effect on the article being produced." Refining the definition further, the regulation states that "[p]roperty 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." *Id*. *See* IC § 6-2.5-5-3(b).

Nonetheless, it should also be noted that "[t]he fact particular property may be considered essential to the conduct of the business of manufacturing because its use is required . . . by practical necessity does not mean that the property 'has an immediate effect upon the article being produced.'" 45 IAC 2.2-5-8(g).

Taxpayer argues that this monitoring device is necessary and integral in the production of printed materials. However, Taxpayer has not established that it is engaged in the "direct production of tangible personal property" such that it qualifies for the manufacturing exemption. Even if Taxpayer did qualify for the exemption, Taxpayer has offered no evidence that the DVS has an "immediate effect" on the printed materials other than to seemingly monitor the quality of those materials. As emphasized under 45 IAC 2.2-5-8(g), the fact that the DVS is required by "practical necessity" does not necessarily mean that the DVS has an immediate or direct effect on the products. Taxpayer has not met its burden under IC § 6-8.1-5-1(c) of establishing that the assessment was wrong.

FINDING

As set out in Part I, B above, Taxpayer's protest of the assessment of tax on transactions representing purchases of exempt services is sustained. In all other respects, Taxpayer's protest is denied.

II. Gross Retail and Use Tax - Negligence Penalty.

DISCUSSION

Taxpayer states that it is entitled to abatement of the Department's ten-percent "negligence" penalty. Taxpayer points to its "compliant filing and payment history."

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(2) requires a ten-percent penalty if the taxpayer "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."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to . . . pay the full amount of tax shown on the person's return . . . or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty."

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care,

caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." *Id*.

Departmental regulation 45 IAC 15-11-2(c) requires that 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 IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment - including the negligence penalty - is presumptively valid.

The Department believes that taxpayer erred in determining its sales and use tax liability. However, there is little indication that Taxpayer's determinations were so egregious as to constitute "willful neglect." Based on a "case-by-case" analysis and after reviewing "the facts and circumstances of each taxpayer" the Department agrees that the ten-percent negligence penalty should be abated.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer's challenge to the assessment of tax on payments for exempt, service transactions is sustained as set out in Part I above. The Department agrees that the ten-percent negligence penalty should be abated. The remaining portion of Taxpayer's protest is respectfully denied.

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