**DEPARTMENT OF STATE REVENUE**

04-20050321.LOF

**Letter of Findings Number: 05-0321**
**Sales and Use Tax**
**For Tax Year 1999-2001**

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## ISSUE

**I. Sales and Use Tax–Imposition**

**Authority:** *Miles, Inc. v. Indiana Department of State Revenue*, 659 N.E.2d 1158, 1163 (Ind. Tax 1995); *Guardian Automotive Trim, Inc. v. Indiana Department of State Revenue*, 811 N.E.2d 979 (Ind. Tax 2004); IC § 6-2.5-5-5.1; IC § 6-2.5-5-6; IC § 6-2.5-5-20; IC § 6-8.1-5-1; 45 IAC 2.2-5-8; Information Bulletin 29 (1994)

Taxpayer protests the assessment of sales and use tax.

**II. Tax Administration–Negligence Penalty**

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

Taxpayer protests the imposition of a ten percent negligence penalty.

## STATEMENT OF FACTS

Taxpayer operates a manufacturing business in Indiana. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments for sales and use taxes. Due to the volume of purchases in the tax period, the Department used a sample and projection method to determine the sales and use taxes due. Taxpayer protests some of those assessments and claims that some of the items listed in the projection are exempt. Further facts will be supplied as required.

**I. Sales and Use Tax–Imposition**

## DISCUSSION

Taxpayer protests the imposition of sales and use tax on several items it purchased during the tax years at issue. First, taxpayer protests the imposition of tax on safety supplies. Taxpayer refers to 45 IAC 2.2-5-8(c)(2)(F), which states:

> 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.
>
> . . .

In its protest, taxpayer states that the Department included items of safety clothing or equipment which qualifies for the exemption found in 45 IAC 2.2-5-8(c)(2)(F). While the Department understands this argument, there is insufficient documentation in the protest file to support taxpayer's assertion that the clothing and taxation of items such as the equipment in question qualifies for the exemption found in 45 IAC 2.2-5-8(c)(2)(F).

Second, taxpayer protests that the Department included Darco, vinyl tarps, acetone and flush solution which are used to prevent contamination of their product during production. Taxpayer refers to *Guardian Automotive Trim, Inc. v. Indiana Department of State Revenue*, 811 N.E.2d 979 (Ind. Tax 2004). In that case, the Indiana Tax Court states:

> Guardian also claims that the "consumption exemption" of 5.1 5.1 *Indiana Code § 6-2.5-5- 5.1* applies to the chemicals (i.e., acetone) it used during mask processing. The consumption exemption provides that
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> > transactions involving tangible personal property are exempt from [sales and use] tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, [or] repairing[.]
>
> *IND. CODE ANN. § 6-2.5-5-5.1(b)* (West 1993) (amended 2002). n14
>
> This exemption is treated, in most respects, identically to the equipment exemption. *Mid-America Energy Res., Inc., 681 N.E.2d at 263*. The parties made the same arguments with respect to both exemptions. The Court therefore finds that Guardian consumed acetone in the "direct production" of "other tangible personal property" and, therefore, is entitled to the consumption exemption.
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> (Id. at 985, internal footnotes omitted)

Since the court explained that IC § 6-2.5-5-5.1 exempts materials consumed in the production of other tangible personal property, and since the materials in question here are consumed in the production of other tangible personal property, taxpayer is correct that the included Darco, acetone and flush solution qualify for the

exemption found in IC § 6-2.5-5-5.1. There is insufficient documentation to support taxpayer's assertion that the tarps are eligible for the exemption found in IC § 6-2.5-5-5.1.

Third, taxpayer protests the Department's taxation of Gatorade, which taxpayer believes was exempt during the audit period. IC § 6-2.5-5-20 provides an exemption for food for human consumption. During the audit period, Information Bulletin 29 explained that the Department considered that Gatorade qualified for the exemption. While the Department has since reissued Information Bulletin 29 without the approval of Gatorade as exempt, taxpayer is correct that Gatorade was exempt from sales tax for the years in question.

Fourth, taxpayer protests that the Department included taxpayer's withdrawal from inventory of one of taxpayer's products. The Department imposed sales tax on the wholesale price of the item, while taxpayer believes that sales tax should only be imposed on the cost of materials. Taxpayer's position is that it should not be charged for the labor involved in producing the item. Taxpayer refers to no statute or regulation in support of its position. Without guidance to the contrary, it is logical for the Department to impose sales tax on the price an ordinary purchaser would pay for the item. Taxpayer did not withdraw the materials out of inventory. Taxpayer withdrew a finished item from inventory, and the Department properly imposed sales tax on that item at the wholesale price.

Fifth, taxpayer protests the imposition of use tax on its purchase of samples and promotional items of which the majority were shipped out of state. The Indiana Tax Court has explained the proper approach to this situation in *Miles, Inc. v. Indiana Department of State Revenue*, 659 N.E.2d 1158, 1163 (Ind. Tax 1995). In that case, the court explained:

> Miles argues that its promotional materials are excepted from use tax under the definition of "storage." "Storage" is defined as "the keeping or retention of tangible personal property in Indiana for any purpose except the subsequent use of that property solely outside Indiana." I.C. 6-2.5-3-1(*b*) (emphasis added).
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> The court determined:
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> Miles is correct. This Court has previously held that the storage exception limits and qualifies the meaning of "use." USAir, Inc. v. Indiana Dep't of State Revenue (1993), Ind. Tax, 623 N.E.2d 466, 470. If property is stored in Indiana for subsequent use outside Indiana, then the activities of storing, handling, and transporting the property cannot be taxed as "uses." Id. To hold otherwise would subsume "storage" within "use," and nullify the exception for subsequent use outside Indiana. Id.
>
> The Court cannot presume the legislature intended to enact a nullity. Id. Therefore, the Court holds that the storage of the promotional items in, and the withdrawal of them from, Miles' Indiana warehouses for shipment out of state do not constitute taxable "uses," but rather fall under the storage exception in I.C. 6-2.5-3-1(b). Accordingly, the promotional materials at issue are not subject to use tax.
>
> (Id., at 1164)

Since some of the samples and promotional items were shipped out of Indiana, taxpayer is correct that those items should not be subject to sales and use tax, as explained in *Miles*.

Sixth, taxpayer protests use tax on the taxpayer's purchase of a prototype which taxpayer later incorporated into a new model item which it sold. Taxpayer refers to IC § 6-2.5-5-6, which states:

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person 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. This exemption includes transactions involving acquisitions of tangible personal property used in commercial printing as described in IC 6-2.1-2-4.

Taxpayer believes that it qualifies for this exemption. The Department was aware of this claim during the audit, and did not allow the exemption due to the lack of documentation establishing that taxpayer actually did incorporate and sell the prototype. Taxpayer did not provide any additional documentation on this subject during the protest process. Therefore, the Department still has not seen sufficient documentation to support taxpayer's claim.

Seventh, taxpayer protests several data entry errors in the error report. Taxpayer states that the audit report has several entries concerning purchases from a single source in which the audit report lists amounts larger than the invoice amount. Any data entry errors shall be reviewed and corrected to reflect the proper amount.

In conclusion, there is insufficient documentation to support taxpayer's claim for the safety equipment exemption. The consumption exemption does apply to the Darco, acetone and flush solution, but not to the vinyl tarps. The Gatorade was exempt during the audit period. The Department imposed tax on the correct amount on the item taxpayer withdrew from inventory. The percentage of samples and promotional items shipped out of Indiana are exempt. There is insufficient documentation to support the claim for incorporation of the prototype. Any data entry errors shall be corrected.

**FINDING**

Taxpayer's protest is sustained in part and denied in part.

**II. Tax Administration–Negligence Penalty**

**DISCUSSION**

Taxpayer protests the imposition of penalty for the years in question. Taxpayer states that it had an error rate

of less than one percent for overall purchase activity for the years in question. The Department refers to IC § 6-8.1-10-2.1(a), which states in relevant part:

If a person:

. . .

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

. . .

the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which 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 reach 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.

45 IAC 15-11-2(c) provides in pertinent part:

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.

In this case, taxpayer incurred a new assessment which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). Taxpayer's reliance on its own calculation of a less than one percent error rate is not supported by statute or regulation. While taxpayer was correct on some of the items it protested in Issue I, taxpayer was incorrect on some of those items, and so did not prove that its failure to pay the assessments on those items was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

**FINDING**

Taxpayer's protest is denied.

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