DEPARTMENT OF STATE REVENUE

04-20070082.LOF

Letter of Findings: 07-0082
Sales and Use Tax
For the Years 2002, 2003, and 2004

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Use Tax – Imposition.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-4-1; IC § 6-2.5-5-6; IC § 6-2.5-5-8; 45 IAC 2.2-5-14.

Taxpayer protests the imposition of use tax on labels it uses in its warehousing and shipping operation.

II. Tax Administration – Negligence Penalty.

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

Taxpayer protests the proposed assessment of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a wholly-owned Delaware subsidiary of a multinational corporation. Taxpayer provides warehousing and shipping services to its parent and other unrelated companies. Both corporations are headquartered in Illinois. Taxpayer has been authorized to do business in Indiana since 1987. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer for the years 2002, 2003, and 2004. Taxpayer was assessed additional use tax on some items, with related interest and penalty. Taxpayer protested only one category of assessed items, labels it argues it permanently affixes to products which it resells to its customers. A hearing was held and this Letter of Findings results. More facts will be presented as necessary.

I. Use Tax – Imposition.

DISCUSSION

An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana. IC § 6-2.5-2-1.

IC § 6-2.5-3-2(a) imposes a complementary 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 location of the transaction or of the retail merchant making the transaction, if sales tax was not paid at the time of the transaction.

The presumption is that tangible personal property acquired in a retail transaction is subject to sales and use tax unless the taxpayer can prove that a specific exemption exists under IC § 6-2.5-5, and the property "is being used, stored, or consumed for the purpose for which it is exempted." IC § 6-2.5-3-4.

Taxpayer argues, in its protest letter dated January 15, 2007, that the labels it permanently affixes to the product are not subject to sales and use tax under both IC § 6-2.5-5-6 and IC § 6-2.5-5-8.

Specifically, Taxpayer argues that tangible personal property is exempt from sales and use tax if the property is acquired for "incorporation as a material part of other tangible personal property which the purchaser manufactures, assembles, refines, or processes for sale in his business." IC § 6-2.5-5-6.

Taxpayer explains that it purchases labels from various vendors and permanently affixes these labels to the product which are sold in the course of business. Taxpayer argues that "Because the labels become an integral component of the finished products, the labels are not subject to tax." Taxpayer points out that even though the Department's audit report states that permanently affixed labels were not taxed, references to invoices relating to these labels are included in audit's report and assessment.

45 IAC 2.2-5-14 states the Department's regulation relating to material incorporated into tangible personal property produced for resale:

> (a) The state gross retail tax shall not apply to sales of any tangible personal property which is to be incorporated by the purchaser as a material or an integral part into tangible personal property produced for sale by such purchaser in the business of manufacturing, assembling, refining or processing.
> (b) The exemption provided by this regulation *[45 IAC 2.2]* applies only to tangible personal property to be incorporated as a material or an integral part into tangible personal property produced for sale by a purchaser engaged in the business of manufacturing, assembling, refining or processing. This regulation *[45 IAC 2.2]* does not apply to persons engaged in producing tangible personal property for their own use.
> (c) This regulation *[45 IAC 2.2]* does not exempt from tax tangible personal property to be used in production, such as supplies, parts, fuel, machinery, etc., refer to Regs. 6-2.5-5-5(010) and 6-2.5-5-5(020) (dealing with material consumed in direct production) for the application of those regulations to taxpayers engaged in the production of tangible personal property.
> (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.

Taxpayer is mistaken in its interpretation of the incorporation exemption. 45 IAC 2.2-5-14(b) stipulates that Taxpayer, as the purchaser of the labels, must be engaged in the business of manufacturing, assembling, refining or processing. Taxpayer provides warehousing and shipping services. Taxpayer is not in the business of manufacturing, assembling, refining, or processing. As a service provider, Taxpayer, therefore, does not qualify for the Indiana sales and use tax incorporation exemption.

Taxpayer argues, in the alternative, that pursuant to IC § 6-2.5-5-8 tangible personal property acquired for resale is exempt from tax. IC § 6-2.5-5-8(b) 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 argues that the labels it purchases qualify for this exemption because it "affixes the labels to the product or packaging and ultimately bills their customers for the cost of the labels. Aside from affixing the labels [to] the product, the labels do not change form and are resold in the ordinary course of [Taxpayer's] business."

According to the Department's audit report Taxpayer has an agreement with each of its customers to perform services for its customers on a cost-plus fixed fee basis. Packaging materials and supplies, labels, etc. are purchased by the Taxpayer. The Taxpayer bills the customer for a monthly service fee. Attached with the customer's monthly bill for Taxpayer's services are sheets detailing the breakdown of man hours and supplies paid for by the Taxpayer. The cost of the various supplies Taxpayer paid for are listed as "pass through charges" on the breakdown. The customer reimburses Taxpayer for these materials at cost, and Taxpayer then adds an administrative fee for the services rendered.

As to the labels, the Department's audit report states the following:

This category includes various kinds of labeling supplies. Included are labels affixed to the shipping carton, hang down labels that will be removed by the taxpayer's customer before the package is shipped to the ultimate customer, labels put on per the customer's request that can be scanned for inventory purposes. Not included in this report are labels that are affixed to the customer's product. As part of the Taxpayer's service, they attach labels with the customer's logo directly onto the customer's products that the taxpayer is packaging for the customer. The labels stay on the product and are never removed. These labels were purchased exempt from tax and have not been included as items to be assessed for tax in this report.

IC § 6-2.5-4-1 defines selling at retail:

(a) A person is a retail merchant making a retail transaction when he engages in selling at retail.

(b) A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he:

(1) acquires tangible personal property for the purpose of resale; and

(2) transfers that property to another person for consideration.

(c) For purposes of determining what constitutes selling at retail, it does not matter whether:

(1) the property is transferred in the same form as when it was acquired;

(2) the property is transferred alone or in conjunction with other property or services; or

(3) the property is transferred conditionally or otherwise.

(d) Notwithstanding subsection (b), a person is not selling at retail if he is making a wholesale sale as described in section 2 of this chapter.

(e) The gross retail income received from selling at retail is only taxable under this article to the extent that the income represents:

(1) the price of the property transferred, without the rendition of any service; and

(2) except as provided in subsection (g), any bona fide charges which are made for preparation, fabrication, alteration, modification, finishing, completion, delivery, or other service performed in respect to the property transferred before its transfer and which are separately stated on the transferor's records.

For purposes of this subsection, a transfer is considered to have occurred after delivery of the property to the purchaser.

Taxpayer is a retail merchant selling at retail because it purchases the labels for the purpose of resale and transfers the labels to its customers for consideration. The Department's audit report substantiates that Taxpayer

has cost-plus agreements with its customers (as quoted above). However, Taxpayer did not show that it collected sales tax on the sale of the labels to its customers. While Taxpayer may qualify for the retail exemption, Taxpayer has to show that it collected sales tax when it resold the labels it had purchased tax-free. Taxpayer has not met its burden to show that it qualifies for the resale exemption.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration – Ten Percent Negligence Penalty.

DISCUSSION

The taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> 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.
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> Additionally 45 IAC 15-11-2(c) states:
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> 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. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and, thus, will be dealt with according to the particular facts and circumstances of each case. In this case, Taxpayer established that its failure to remit Indiana sales and use tax was due to reasonable cause and not due to negligence.

FINDING

Taxpayers' protest is sustained.

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