

**Letter of Findings: 08-0554
Sales and Use Tax
For the Year 2005, 2006, and 2007**

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ISSUES

I. Sales and Use Tax – Imposition.

Authority: IC § 6-2.5-1-1 et seq.; IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-5-3; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; [45 IAC 2.2-4-27](#); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-11](#); [45 IAC 2.2-5-16](#); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the assessment of tax on purchases and rentals of tangible personal property.

II. Tax Administration – Penalty.

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer, an Indiana corporation, buys raw lumber from sawmills which it then cuts to standard lengths, sorts, grades, air dries, and kiln dries before Taxpayer sells its products. Pursuant to an audit, the Department of Revenue ("Department") assessed sales and/or use tax on several of Taxpayer's purchases and rentals of tangible personal property. Taxpayer protested the Department's assessment. A hearing was held. The Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Imposition

DISCUSSION

The Department assessed use tax on Taxpayer's purchases of several items of tangible personal property because Taxpayer did not pay sales tax on the items at the time of the purchases. The Department also assessed use tax on Taxpayer's rental and leasing of vehicles.

Taxpayer protested the Department's assessment. Taxpayer first argued that it purchased the tangible personal property to use in its manufacturing process, so Taxpayer claimed that it was entitled to exemptions from sales tax on those transactions. Taxpayer agreed that it should have paid sales tax on the rental and leasing of vehicles, but Taxpayer argued that it is only liable for sales tax on the fixed monthly rental charge and not on the mileage charge and cost of repairs (per Taxpayer's lease agreement). Additionally, Taxpayer claimed that the Department's audit over-assessed tax on two checks paid to the lessor because, in addition to the rental charges, the two checks included payments that Taxpayer reimbursed the lessor for cost of fuel, which Taxpayer had paid tax at the pump when it infused the fuel.

All tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

A. Exempt Transactions of Retail Merchant

The Department audit assessed use tax on Taxpayer's purchases of poly bags, tally sheets, strapping carts, and strapping equipment because Taxpayer did not pay sales tax at the time of the transactions. Taxpayer argued that it purchased poly bags, tally sheets, strapping carts, and strapping equipment to use in its manufacturing process, so those items were exempt from sales tax.

Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq.

IC § 6-2.5-2-1 provides:

(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.

IC § 6-2.5-3-2 provides:

(a) 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.

Generally, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable. [45 IAC 2.2-5-8\(a\)](#). An exemption from use tax is granted for transactions where the gross retail tax ("sales tax") was paid at the time of purchase pursuant to IC § 6-2.5-3-4. There are also additional exemptions from sales tax and use tax.

1. Manufacturing Exemption – Poly Bags and Tally Sheets

The Department's audit determined that the poly bags and the tally sheets were taxable because both the poly bags and the tally sheets were not directly used in the direct manufacturing process. Poly bags are see-through clear plastic bags, stapled to Taxpayer's lumber, that hold and protect tally sheets inside. The tally sheets are inserted inside the poly bags to identify grades of lumber as well as to track and to locate the lumber. Taxpayer, however, claimed that the poly bags and tally sheets were exempt from sales tax because Taxpayer used them to identify the products through the manufacturing process. Without the poly bags and the tally sheets, Taxpayer claimed the manufacturing process could not continue.

IC § 6-2.5-5-3(b), in pertinent part, states:

[T]ransactions 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.

IC § 6-2.5-5-1(b) provides, in part:

Transactions involving tangible personal property are exempt from the state gross retail 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, repairing, mining, agriculture, horticulture, floriculture, or arboriculture.

The exemption applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. Id. Machinery, tools, and equipment are directly used in the production process if they have an immediate effect on the article being produced. [45 IAC 2.2-5-8\(c\)](#). A machine, tool, or piece of equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. Id. An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." [45 IAC 2.2-5-8\(c\)](#), Example 1.

[45 IAC 2.2-5-8\(k\)](#) describes "direct production" as the performance of an integrated series of operations which transforms the matter into a form, composition or character different from that in which it was acquired, and that the change must be substantial resulting in a transformation of the property into a different and distinct product.

The exemption for direct use in production is further explained at [45 IAC 2.2-5-11](#), in part, as follows:

(a) The state gross retail tax shall not apply to sales of tangible personal property to be directly used by the purchaser in the direct production or manufacture of any manufacturing or agricultural machinery, tools, and equipment described in [IC 6-2.5-5-2](#) or 6-2.5-5-3 [[IC 6-2.5-5-3](#)].

(b) The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to tangible personal property directly used in the direct production of manufacturing or agricultural machinery, tools, and equipment to be used by such manufacturer or producer.

(c) The state gross retail tax shall not apply to purchases of tangible personal property to be directly used by the purchaser in the production or manufacturing process of any manufacturing or agricultural machinery, tools, or equipment, provided that the machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect upon the article being produced or manufactured. The 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.

(d) For the application of the rules [subsections] above, refer to Regs. 6-2.5-5-3 [[45 IAC 2.2-5-8](#) through [45 IAC 2.2-5-10](#)] with respect to tangible personal property used directly in the following activities:

pre-production and post-production activities; storage; transportation; tangible personal property which has an immediate effect upon the article produced; maintenance and replacement; testing and inspection; and managerial, sales, and other nonoperational activities.

Finally, [45 IAC 2.2-5-8\(d\)](#) states:

Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

Taxpayer's documentation showed that the tally sheets were inserted into the poly bags and the poly bags were stapled to the lumber. However, Taxpayer's documentation showed that the poly bags and the tally sheets did not have an immediate impact on Taxpayer's production and were not used in direct production. Instead, Taxpayer's documentation showed that Taxpayer uses the poly bags and the tally sheets to label its products because doing so is an easy and convenient method to identify, track, and locate its products. The fact that the tally sheets and poly bags may be considered essential to the conduct of the business of manufacturing because their use is required by practical necessity does not itself mean that the items have an immediate effect upon the article being produced. [45 IAC 2.2-5-8 \(g\)](#).

The poly bags and the tally sheets are not used in direct production, nor did they have an immediate effect on the article being produced. Thus, Taxpayer is not entitled to exemption.

2. Wrapping Materials and Containers Exemption – Strapping Carts and Strapping Equipment

Pursuant to [45 IAC 2.2-5-16](#), the Department's audit exempted steel strapping material Taxpayer used to secure its lumber for shipping. However, the Department assessed use tax on Taxpayer's strapping carts and strapping equipment, including tinchers and crimpers. According to Taxpayer's documentation, strapping carts were used to hold and move strapping machines, which held the steel strapping used to package the lumber. The tincher, a bending tool, is used to tighten the steel strapping around the lumber. The crimper is used to fasten the two ends of steel strapping. Taxpayer argued that strapping carts and strapping equipment were essential to manipulate the steel strapping used to package and secure the lumber during shipping. Without strapping carts and strapping equipment, Taxpayer claimed that it could not complete packaging its products.

[45 IAC 2.2-5-16](#), in pertinent part, states:

(a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers sold empty for refilling.

(c) The receipt from a sale by a retail merchant of the following types of tangible personal property are exempt from state gross retail tax:

(1) Nonreturnable containers and wrapping materials including steel strap and shipping pallets to be used by the purchaser as enclosures for selling tangible personal property.

The tools and equipment Taxpayer uses to transport and secure the strapping steel to the lumber do not fall under the "nonreturnable containers and wrapping materials" exemption. [45 IAC 2.2-5-16](#) refers to the actual "nonreturnable containers and wrapping materials" – in this case, the strapping steel that contains the lumber, which was properly exempted by the Department's audit. Since this is a post-production process, the use of tools and equipment in this context are outside the ambit of the manufacturing exemption that applies to tools and equipment directly used in the direct manufacturing process. Only the "nonreturnable containers and wrapping materials" themselves qualify for the exemption stated in [45 IAC 2.2-5-16](#).

Thus, Taxpayer is not entitled to exemption regarding the purchase of strapping carts and strapping equipment under [45 IAC 2.2-5-16](#).

B. Lease of Tangible Personal Property

The Department determined that Taxpayer should have paid sales tax on the vehicles it had leased from its lessor. The amount should have included (1) fixed monthly rental fees, (2) charges related to use of additional mileage, and (3) cost of repairs. The Department's audit compiled relevant information from Taxpayer's lease invoices, which Taxpayer received from its lessor. However, two invoices were missing, so the Department's audit referred to two checks Taxpayer paid to the lessor.

Taxpayer agreed that it should have paid sales tax on the fixed monthly fees, but argued that it should not be held liable for use tax concerning other charges, such as use of additional mileage and cost of repairs. Taxpayer also argued that the two checks, which the Department's audit listed and referred to in the audit summary, included Taxpayer's reimbursement to its lessor for the usage of fuel, for which Taxpayer had paid tax at the pump.

1. Sales and/or Use Tax on Rental and Leasing of Vehicles

The Department's audit assessed use tax on Taxpayer's rental vehicles because Taxpayer did not pay sales tax at the time the rental transactions took place. Taxpayer argued that it should only be liable for sales tax on the fixed monthly charges based on the vehicle lease service agreement.

[45 IAC 2.2-4-27](#) states:

(a) In general, the gross receipts from renting or leasing tangible personal property are taxable. This regulation [[45 IAC 2.2](#)] only exempts from tax those transactions which would have been exempt in an equivalent sales transaction.

(b) Every person engaged in the business of the rental or leasing of tangible personal property, other than a public utility, shall be deemed to be a retail merchant in respect thereto and such rental or leasing transaction shall constitute a retail transaction subject to the state gross retail tax on the amount of the actual receipts from such rental or leasing.

(c) In general, the gross receipts from renting or leasing tangible personal property are subject to tax. The rental or leasing of tangible personal property constitutes a retail transaction, and every lessor is a retail merchant with respect to such transactions. The lessor must collect and remit the gross retail tax or use tax on the amount of actual receipts as agent for the state of Indiana. The tax is borne by the lessee, except when the lessee is otherwise exempt from taxation.

(d) The rental or leasing of tangible personal property, by whatever means effected and irrespective of the terms employed by the parties to describe such transaction, is taxable.

(1) Amount of actual receipts. The amount of actual receipts means the gross receipts from the rental or leasing of tangible personal property without any deduction whatever for expenses or costs incidental to the conduct of the business. The gross receipts include any consideration

received from the exercise of an option contained in the rental of lease agreement; royalties paid, or agreed to be paid, either on a lump sum or other production basis, for use of tangible personal property; and any receipts held by the lessor which may at the time of their receipt or some future time be applied by the lessor as rentals.

(2) Rental or lease period. For purposes of the imposition of the gross retail tax or use tax on rental or leasing transactions, each period for which a rental is payable shall be considered a complete transaction. In the case of a weekly rate, each week shall be considered a complete transaction. In the case of a continuing lease or contract, with or without a definite expiration date, where rental payments are to be made monthly or on some other periodic basis, each payment period shall be considered a completed transaction.

(3) Renting or leasing property with an operator:

(A) The renting or leasing of tangible personal property, together with the services of an operator shall be subject to the tax when control of the property is exercised by the lessee. Control is exercised when the lessee has exclusive use of the property, and the lessee has the right to direct the manner of the use of the property. If these conditions are present, control is deemed to be exercised even though it is not actually exercised.

(B) The rental of tangible personal property together with an operator as part of a contract to perform a specific job in a manner to be determined by the owner of the property or the operator shall be considered the performance of a service rather than a rental or lease provided the lessee cannot exercise control over such property and operator.

(C) When tangible personal property is rented or leased together with the service of an operator, the gross retail tax or use tax is imposed on the property rentals. The tax is not imposed upon the charges for the operator's services, provided such charges are separately stated on the invoice rendered by the lessor to the lessee.

(D) Notwithstanding any other provision of this regulation [\[45 IAC 2.2\]](#) any lessee leasing or renting a vehicle(s) from any lessor, including an individual lessor, with or without operators, driver(s), or even if the operator (driver) himself is the lessor, regardless of control exercised, shall not be subject to the gross retail tax or use tax, if the leased or rented vehicle(s) are directly used in the rendering of public transportation.

(4) Supplies furnished with leased property. A person engaged in the business of renting or leasing tangible personal property is considered the consumer of supplies, fuels, and other consumables which are furnished with the property which is rented or leased. (**Emphasis added**).

Here, Taxpayer's vehicle lease service agreement showed that, in addition to a fixed monthly rental charge, Taxpayer is also responsible for paying mileage charge and repair costs. Taxpayer's documentation showed that the lessor billed Taxpayer separately for the charges. Taxpayer made monthly payment via check on which it itemized the lessor's invoices and totaled its amount due. Based upon Taxpayer's documentation, the Department's audit correctly assessed use tax on charges for use of additional mileage listed in Taxpayer's invoices and cost of repairing rental vehicles.

Pursuant to [45 IAC 2.2-4-27\(d\)\(1\)](#), Taxpayer is liable for tax on the fixed monthly rental fees, charges for use of additional mileage, and cost related to repairs of rental vehicles.

2. Over-assessment of Sales and/or Use Tax

To calculate sales and/or use tax on Taxpayer's rental of vehicles, the Department's audit listed Taxpayer's invoices that related to the vehicle leases. However, because a couple of invoices were missing, the Department's audit listed two checks as replacements of two invoices and assessed the amount of the checks. Taxpayer argued that the two checks listed in the audit summary were payments that included Taxpayer's reimbursement to its lessor for the fuel charges, for which Taxpayer had paid tax at the pump. Taxpayer stated that it used the lessor's fuel card to receive a discount whenever Taxpayer filled the rental vehicles' tanks. Taxpayer then reimbursed the lessor for the cost of the fuel. Thus, Taxpayer claimed that the Department's audit mistakenly assessed additional sales tax it had already paid at the pump.

Taxpayer has provided sufficient documentation showing that Taxpayer's two checks were the payment for both the lease charges and the fuel charges. Additionally, Taxpayer's documentation showed that Taxpayer had paid tax at the pump when it filled the rental vehicles' tanks. Thus, the Department will recalculate the assessment in a supplemental audit.

FINDING

Taxpayer is sustained on the over-assessment of two checks. However, Taxpayer is respectfully denied on all other issues.

II. Tax Administration – Penalty.

DISCUSSION

Taxpayer also protests the assessment of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1, the Department may assess a ten (10) percent negligence penalty if the taxpayer:

- (1) fails to file a tax return;
- (2) fails to pay the full amount of tax shown on the tax return;
- (3) fails to remit in a timely manner the tax held in trust for Indiana (e.g., a sales tax); or
- (4) fails to pay a tax deficiency determined by the Department to be owed by a taxpayer.

[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 as provided in [45 IAC 15-11-2](#)(c), in part, as follows:

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:

- (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.

Taxpayer has demonstrated that its failure to pay the full amount of tax due or pay a deficiency was due to reasonable cause and not due to negligence. Thus, Taxpayer's protest on the imposition of negligence penalty is sustained.

FINDING

Taxpayer's protest on imposition of negligence penalty is sustained.

SUMMARY

For the reasons discussed above, Taxpayer is sustained regarding the Department's over-assessment of the two checks. Taxpayer's protest on negligence penalty is also sustained. However, Taxpayer is respectfully denied on all other issues.

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