DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 08-0655
Use Tax
For Tax Years 2005-07

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ISSUES

I. Use Tax–Transportation Services.

Authority: IC § 6-2.5-1-21; IC § 6-2.5-3-2; IC § 6-2.5-5-27; IC § 6-8.1-5-1; 45 IAC 2.2-5-61; 45 IAC 2.2-5-63.

Taxpayer protests the imposition of use tax on payments for transportation of its product.

II. Use Tax–Case Erector.

Authority: IC § 6-2.5-5-3; IC § 6-2.5-5-9.

Taxpayer protests the imposition of use tax on the purchase of a case erector.

III. 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 is an out-of-state business operating in Indiana. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit for the tax years 2005, 2006, and 2007. As the result of the audit, the Department issued proposed assessments for use tax, interest, and a ten percent negligence penalty. Taxpayer protests the imposition of use tax on amounts paid to a wholly-owned subsidiary ("Sub") for what it states are charges for delivery services and on the purchase of a case erector, as well as the ten percent negligence penalty. Sub does not file an Indiana adjusted gross income tax return. Taxpayer and Sub are included on the federal return of a common parent. Taxpayer states that Sub is a properly registered motor carrier. Taxpayer also states that a case erector qualifies for the manufacturing exemption. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Use Tax–Transportation Services.

DISCUSSION

Taxpayer protests the imposition of use tax on payments made to Sub in connection with transportation of its product. The Department considered the payments to be rental payments for delivery trucks. Taxpayer states that the payments were for transportation services which were provided by the subsidiary. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

The Department imposed use tax on the payments made from Taxpayer to Sub after the Department determined that those payments were for the rental of delivery vehicles. Taxpayer did not pay sales tax on those transactions and so use tax was imposed. The use tax is imposed under IC § 6-2.5-3-2, which states in relevant part:

> (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.
> (b) The use tax is also imposed on the storage, use, or consumption of a vehicle, an aircraft, or a watercraft, if the vehicle, aircraft, or watercraft:
> (1) is acquired in a transaction that is an isolated or occasional sale; and
> (2) is required to be titled, licensed, or registered by this state for use in Indiana.....

Furthermore, 45 IAC 2.2-5-8 explains in relevant part:

> (a) In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. The exemption provided in this regulation [45 IAC 2.2] extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.
> ...
> (f) Transportation equipment.
> (1) Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.
> (2) Tangible personal property used for moving finished goods from the plant after manufacture is subject to tax.
> (3) Transportation equipment used to transport work-in-process or semi-finished materials to or from

storage is not subject to tax if the transportation is within the production process.

(4) Transportation equipment used to transport work-in-process, semi-finished, or finished goods between plants is taxable, if the plants are not part of the same integrated production process.

(Emphasis added).

....

The Department categorized the rental of the vehicles as the rental of tangible personal property used for moving finished goods from the plant after manufacture, as described by 45 IAC 2.2-5-8(f)(2). As explained in the audit report, the Department based its determination on several factors. One was that truck rentals initially were charged to a pre-paid rental expense account of Taxpayer's. Each month, journal entries removing those amounts from the initial account to Taxpayer's different distribution or manufacturing rental expense accounts were made. Fuel purchases and repair parts were charged to another Taxpayer account. While a separate checking account was used by Sub to pay the truck leasing companies, all expenses were charged to Taxpayer's banking accounts. The audit report includes a memorandum to Taxpayer's accountant explaining that Taxpayer and Sub would not have separate accounting and that all of Sub's payables and receivables would be automatically assumed to be Taxpayer's. The audit report also includes a letter from a certified public accountant to Taxpayer's parent company which discusses Indiana rules regarding "lease payments" between Taxpayer and Sub.

Another reason was that Taxpayer's parent company's 2006 federal return included the parent, Taxpayer, and Sub. The federal return listed only two line items for Sub. The first line item was for gross rents income and the second line item was a rent deduction. Sub reported no gross profit. A supporting schedule shows that the rent deduction was for truck rents. The two line items offset each other. The supporting schedule reports that Sub had no deductions for payroll, employee benefits, insurance, permits, fees, or any other deduction besides the truck rent deduction.

The Department determined that, since the truck rental charges were initially charged to Taxpayer's accounts, the fuel and repair parts were charged to Taxpayer's accounts, and the parent company reported to the federal government that Sub's only income derived from rentals, Taxpayer was not paying Sub for delivery services but was paying to rent trucks from Sub. This led to the Department's conclusion that Taxpayer was transporting its own property in the trucks it leased from Sub. Therefore, the Department issued the proposed assessments for use tax on the payments from Taxpayer to Sub.

After the Department issued its proposed assessments, Taxpayer submitted a written protest of the assessments. In the protest process, Taxpayer submitted a written transportation agreement with Sub. Sub employs no drivers of its own. Rather, it has an agreement with Taxpayer to lease Taxpayer's drivers to drive the vehicles. Sub has provided documentation to establish that it has lease agreements with truck leasing companies and that it pays those companies for truck rental/leases, fuel, and maintenance services via its separate checking account.

Taxpayer protests that Sub is an independent company which is properly registered to operate as a motor carrier. Taxpayer states that, since Sub had control over the drivers, IC § 6-2.5-1-21 made it impossible to tax the transactions. Sub paid Taxpayer for the lease of Taxpayer's drivers from a separate bank account. Taxpayer believes that these factors all establish Sub's independent status and that Sub therefore hauled the property of Taxpayer as a delivery service. Taxpayer dismisses the information on the federal return as mislabeling and meaningless bookkeeping errors.

In the protest process, the Department inquired whether or not the payments from Taxpayer to Sub and the payments from Sub to Taxpayer were conducted at arm's-length. Taxpayer states that not only were the payments at arm's-length, but that Indiana was prohibited from attempting to set transportation rates by federal rules and regulations. The Department takes this opportunity to explain that it is not attempting to impose any particular rate on the payments between Taxpayer and Sub. For Indiana sales and use tax purposes, Taxpayer and Sub may set any rate they see fit to set. The only relevancy in the instant case is whether or not the rates were sufficient to qualify as legitimate payments and not simply token payments.

As explained in the audit report, the Department acknowledges that Sub pays the truck leasing companies from a separate checking account. The Department also points out that the fact that Sub has a separate checking account is counterbalanced by the fact that Taxpayer and Sub do not maintain separate accounting. The Department also recognizes that Sub is registered with the appropriate authorities to operate as a carrier. However, as provided by 45 IAC 2.2-5-61(b), that fact alone will not determine if a company is actually providing public transportation services. While there is a transportation agreement and funds were transferred between Taxpayer and Sub, it is not clear that those transfers arose under the terms of the transportation agreement. The information on the federal return clearly states that Sub's only income comes from rents. While Taxpayer states that this is a simple case of mislabeling, the Department cannot agree that reporting contradictory information to the federal taxing authority and the state taxing authority is a simple matter. This is particularly true when the contradictory information results in a substantially reduced tax liability to the state.

In conclusion, Taxpayer has the burden of proving that the proposed assessments are wrong, as provided by IC § 6-8.1-5-1(c). While Sub does possess some of the indicia of independence from Taxpayer, it also possesses some of the indicia of dependence on Taxpayer. The fact that Taxpayer's parent reported Sub as only collecting

rents to the federal government, the fact that Taxpayer and Sub have a shared accounting process, and the fact that Taxpayer's parent company's accountants discussed the "leasing" arrangement between Taxpayer and Sub all support the Department's determination that Sub was not acting as an independent delivery services company. Taxpayer has not met the burden imposed under IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is denied.

II. Use Tax–Case Erector.

DISCUSSION

Taxpayer protests the imposition of use tax on the purchase of a case erector, which folds and tapes completed boxes out of pre-formed cardboard cut-outs. Taxpayer states that the cases are the final packaging for its product and that the production process is not complete until the cases are filled with the product. The Department imposed use tax on the purchase of the case erector after determining that the equipment was not part of the production process. The relevant statute is IC § 6-2.5-5-3, which states:

(a) For purposes of this section:

(1) the retreading of tires shall be treated as the processing of tangible personal property; and

(2) commercial printing shall be treated as the production and manufacture of tangible personal property.

(b) 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.

(c) The exemption provided in subsection (b) does not apply to transactions involving distribution equipment or transmission equipment acquired by a public utility engaged in generating electricity.

(Emphasis added.)

Also, IC § 6-2.5-5-9 provides:

(a) As used in this section, "returnable containers" means containers customarily returned by the buyer of the contents for reuse as containers.

(b) Sales of returnable containers are exempt from the state gross retail tax if the transaction constitutes selling at retail as defined in IC 6-2.5-4-1 and if the returnable containers contain contents.

(c) Sales of returnable containers are exempt from the state gross retail tax if the containers are transferred empty for the purpose of refilling.

(d) Sales of wrapping material and empty containers are exempt from the state gross retail tax if the person acquiring the material or containers acquires them for use as nonreturnable packages for selling the contents that he adds.

(Emphasis added.)

The Department determined that the case erector only formed the cardboard cases which Taxpayer later filled with its product. The exemption found at IC § 6-2.5-5-9(d) is for wrapping and packaging materials, not the machinery which affects the materials prior to the introduction of the items to be wrapped or packaged. The exemption found at IC § 6-2.5-5.3(b) is also unavailable since the case erector forms the cardboard cases in a separate step from the production process. Taxpayer's products are the items which fill the boxes, not the boxes themselves. Taxpayer does not produce and sell boxes. The case erector is separate from Taxpayer's production process and is not eligible for the exemptions for manufacturing and for packaging.

FINDING

Taxpayer's protest is denied.

III. Tax Administration–Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax year in question. Taxpayer protests the imposition of penalty. 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 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.

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 deficiency 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 has not affirmatively established that its failure to pay the deficiency 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.

CONCLUSION

Taxpayer is denied on Issue I regarding imposition of use tax on lease payments. Taxpayer is denied on Issue II regarding imposition of use tax on the case erector. Taxpayer is denied on Issue III regarding imposition of negligence penalty.

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