DEPARTMENT OF STATE REVENUE

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Letter of Findings: 09-0563
Gross Retail and Use Tax
For Years 2005, 2006, and 2007

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ISSUES

I. Out-of-State Sales – Gross Retail Tax.
Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2(a); IC § 6-8.1-5-1(c).

Taxpayer objects to the sales tax calculation for the year 2007 on the ground that the "total sales" stipulated for 2007 includes out-of-state sales; these are sales which purportedly occurred at one of taxpayer's out-of-state locations to out-of-state customers.

II. Statistical Sampling – Audit Methodology.
Authority: IC § 6-8.1-4-2; IC § 6-8.1-5-1(c).

Taxpayer challenges the "stratified sampling" method used to determine the error rate for the years 2005, 2006, and 2007.

III. Out-of-State Purchases – Gross Retail Tax.
Authority: IC § 6-2.5-3-2(a); IC § 6-2.5-5-3(b); IC § 6-8.1-5-1(c).

Taxpayer argues that the list of 2005, 2006, and 2007 retail purchases incorrectly includes purchases which were made in Michigan or Ohio and "used" at one of taxpayer's out-of-state locations.

IV. Fertilizer Storage Facility – Gross Retail Tax.
Authority: IC § 6-2.5-5-3(b); IC § 6-8.1-5-1(c); 45 IAC 2.2-5-10(k).

Taxpayer maintains that it is entitled to a refund of sales tax paid on the purchase of a fertilizer storage facility on the ground that the facility is used to manufacture agricultural products.

V. Petroleum Bulk Plant – Gross Retail Tax.
Authority: IC § 6-2.5-5-3(b); 45 IAC 2.2-5-10(k).

Taxpayer states that materials used to construct or upgrade its bulk petroleum plant facility are not subject to Gross Retail Tax because the plant is used to manufacture petroleum products.

VI. Chemical Containment Dikes – Gross Retail Tax.
Authority: IC § 6-2.5-5-3; 45 IAC 2.2-3-8; 45 IAC 2.2-5-70.

Taxpayer maintains that the materials used to construct chemical containment dikes are not subject to Gross Retail Tax because the dikes are mandated by federal, state, or local laws.

STATEMENT OF FACTS

Taxpayer is a member-owned supply and marketing business operation representing a partnership of four cooperative businesses. Taxpayer has multiple Indiana retail locations along with locations outside the state. Taxpayer sells gasoline, diesel, and propane fuel. Taxpayer also sells other petroleum products such as hydraulic fluid. In addition, taxpayer sells various agricultural related products such as animal feed.

The Indiana Department of Revenue (Department) conducted an audit review of taxpayer's records. That audit resulted in the assessment of additional sales/use tax. Taxpayer disagreed with certain of the audit results and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Out-of-State Sales – Gross Retail Tax.

DISCUSSION

Pursuant to IC § 6-2.5-2-1, a sales tax, known as state Gross Retail Tax, is imposed on retail transactions made in Indiana unless a valid exemption is applicable. Retail transactions involve the transfer of tangible personal property. IC § 6-2.5-3-2(a). However, Taxpayer claims that the audit erred when it failed to exclude from its 2007 sales, those transactions purportedly made at one of taxpayer's out-of-state locations to an out-of-state customer. For example, an Ohio customer purchased an item at one of taxpayer's Ohio outlets.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

Taxpayer has provided information sufficiently detailed to justify its claim that the audit may have included out-of-state sales in the listing of "total sales" for 2007. Taxpayer has not proven that the "total sales" listed is incorrect but has met the burden imposed under IC § 6-8.1-5-1(c) sufficient to justify requesting that a supplemental audit be conducted, that taxpayer's information be reviewed, and that the original assessment be modified as warranted.

FINDING

Taxpayer's protest is sustained subject to the results of the supplemental audit review.

II. Statistical Sampling – Audit Methodology.

DISCUSSION

The audit report states that, "Due to the large number of sales transaction[s] made by the taxpayer, the taxpayer and the Department agreed to a projection based on the stratified sampling method to determine the audit results for all three audit years 2005, 2006 and 2007. The projection method was discussed with the taxpayer and agreed to by the taxpayer." (Emphasis added).

Taxpayer objects to the final results but admits that it "has no working knowledge of the stratified statistical approach." Nonetheless, taxpayer explains that the audit determined an error percentage of approximately 14 percent but that taxpayer's own alternative recalculation results "in a total error percentage of 7 [percent]."

The Department may, of course, examine the books, records, or other data bearing on the correctness of the returns. IC § 6-8.1-4-2. As noted above, the notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC § 6-8.1-5-1(c).

The Department agrees that a recalculation of taxpayer's sales and use tax liabilities could very well result in a different result than the one reached by the audit. However, an administrative hearing is not the appropriate forum by which to explore statistical variances and methodologies. Having protested the audit results, it is the taxpayer's burden of demonstrating that the sampling method is wrong. Taxpayer has demonstrated that there is an alternative methodology but failed to demonstrate clear error on the part of the audit.

FINDING

Taxpayer's protest is respectfully denied.

III. Out-of-State Purchases – Gross Retail Tax.

DISCUSSION

Taxpayer argues that the list of 2005, 2006, and 2007 retail purchases incorrectly includes purchases which were made in Michigan or Ohio and never "used" in Indiana. IC § 6-2.5-3-2(a) provides that, "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 of that transaction or of the retail merchant making that transaction." Taxpayer maintains that certain transactions should not been subjected to use tax because the items purchased were never "used" in Indiana. In other words, items were purchased at an out-of-state location and were never "used" at one of taxpayer's Indiana locations.

Taxpayer has provided information which it deems sufficient to establish that the audit included exempt items in its listing of 2005, 2006, and 2007 retail purchases subject to use tax. As noted above in Part I, the information provided by taxpayer is sufficient to warrant review by the supplemental audit. Taxpayer has not proven that the original use tax assessment was incorrect but has met the burden under IC § 6-8.1-5-1(c) sufficient to justify requesting that a supplemental audit be conducted, that taxpayer's information be reviewed, and that the original assessment be modified as warranted.

FINDING

Taxpayer's protest is sustained subject to the results of the supplemental audit review.

IV. Fertilizer Storage Facility – Gross Retail Tax.

DISCUSSION

The Department's audit imposed "use tax on the purchases of tangible personal property which were delivered to the taxpayer for use or consumption and on which sales tax was not paid at the time of purchase nor the use tax remitted to the Indiana Department of Revenue."

Included in the use tax assessment was "material handling and blending equipment for their fertilizer storage facility." This equipment was subjected to use tax despite taxpayer's opinion that it is "operating a plant food manufacturing facility and that all purchases for this facility are exempt."

The audit came to a different conclusion concluding that taxpayer "is not entitled to the manufacturing exemption for the facility" because taxpayer "does not manufacture the fertilizer." Instead taxpayer simply "purchases various dry fertilizers from suppliers and stores the various types of dry fertilizer in storage bins... located in their 'blend towers.'" The audit report continues: "The taxpayer then either sells the fertilizer or custom blends a combination of fertilizers to meet their customer's requirement. The taxpayer's customer receives 'custom blended fertilizer.'" The audit concluded that taxpayer was not manufacturing fertilizer but was simply providing a "service to custom blend the fertilizer...."

IC § 6-2.5-5-3(b) provides an exemption from sales tax for "manufacturing machinery, tools, and equipment... if the person acquiring the property acquires it for direct use in the direct production... [or] processing... of other tangible personal property."

The Department refers to 45 IAC 2.2-5-10(k), which states:

> Processing or refining is defined as the performance by a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change. Operations such as

distilling, brewing, pasteurizing, electroplating, galvanizing, anodizing, impregnating, cooking, heat treating, and slaughtering of animals for meal or meal products are illustrative of the types of operations which constitute processing or refining, although any operation which has such a result may be processing or refining. A processed or refined end product, however, must be substantially different from the component materials used.

(Emphasis added.)

As noted previously, IC § 6-8.1-5-1(c) provides, "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

Taxpayer has provided "Building Specifications" prepared by the contractor which originally constructed the fertilizer plant. The specifications stipulate that "all sales tax" is included the agreement to construct the plant. In addition, the contractor provided a description of the fertilizer plant operation as follows:

Straight dry fertilizer is brought into this facility by train, railcar loads. Railcars hold approximately 100 tons of fertilizer and there are usually 75 to 100 railcars per train. The fertilizer is stored in three large bins: bin #1 – 14,000 tons, bin #2 – 3,000 tons, and bin #3 – 7,000 tons. The three binds hold three different dry fertilizer raw products; potash, phosphates, and urea. From storage, the fertiliz[er] then goes through a manufacturing process, which includes being reconditioned and blended, before it is loaded [onto] trucks for shipment to a retailer or end user. The manufacturing, reconditioning and blending process is a series of hoppers, belts and conveyors, legs and chutes, bucket elevator, and a large stainless steel drum blender. Raw straight product dry fertilizer is processed and flows through the system, reconditioned into consistent granular sizes and foreign material removed. Two or more of the recondite dry fertilizer[s] are then sometimes deliberately and carefully blended together to obtain a mixture (blend) of the desired nutrients in a predetermined ratio and concentration. The manufactured blended product is used directly on the fields for the purpose of conveniently getting the correct nutrients required in that soil to grow certain crops in the most efficient and cost effective manner.

As to taxpayer's primary contention, the Department is unable to agree that the fertilizer plant is exempt; the plant is not employed in the "direct use in the direct production... [or] processing... of other tangible personal property." The Department disagrees because it does not find that the blended fertilizer is "substantially different from the component materials used." "Blended fertilizer" remains essentially "fertilizer."

As to taxpayer's second contention, the Department is unable to agree that the construction company's statement – that the storage facility was constructed pursuant to a "lump sum contract where [construction company] paid either sales tax at the time the materials were purchased, or use tax at the time the materials were incorporated into the property" – is entirely dispositive of the issue raised. The acquisitions for which use tax was assessed were acquired from vendors other than the construction company as listed on page 13 and 14 of the audit report.

FINDING

Taxpayer's protest is respectfully denied.

V. Petroleum Bulk Plant – Gross Retail Tax.

DISCUSSION

Taxpayer argues that the materials used to construct the petroleum bulk plants are exempt because the "blending process for liquid fuels is manufacturing." Taxpayer explains that "we create a new fuel that has a different ASTM number, which means it burns [at] a different temperature and freezes at a different temperature."

Taxpayer concludes that the petroleum bulk plant facilities are directly used in the direct production of other tangible personal property and therefore qualify for the "manufacturing equipment exemption" under IC § 6-2.5-5-3(b).

IC § 6-2.5-5-3(b) provides an exemption from sales tax for "manufacturing machinery, tools, and equipment... if the person acquiring the property acquires it for direct use in the direct production... [or] processing... of other tangible personal property."

The Department again references 45 IAC 2.2-5-10(k), which states:

Processing or refining is defined as the performance by a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change. Operations such as distilling, brewing, pasteurizing, electroplating, galvanizing, anodizing, impregnating, cooking, heat treating, and slaughtering of animals for meal or meal products are illustrative of the types of operations which constitute processing or refining, although any operation which has such a result may be processing or refining. A processed or refined end product, however, must be substantially different from the component materials used.

(Emphasis added.)

The Department is unable to agree that taxpayer has met its burden of demonstrating that the bulk plant facilities are exempt from sales/use tax because the equipment is not used for "direct use in the direct production... [or] processing... of other tangible personal property." IC § 6-2.5-5-3(b). The facility is equipped to

blend different grades of liquid fuels which, although altering the characteristics of the final product, does not produce an end product which is "substantially different from the components used." 45 IAC 2.2-5-10(k). Blended diesel fuel is still essentially "diesel fuel." Blended kerosene is still essentially "kerosene." Blending ethanol with gasoline produces a product which is still recognizably and functionally gasoline.

Because taxpayer's bulk plant facilities are not directly engaged in the direct production of a substantially different product than the elements which go into that production process, taxpayer's protest must be denied.

FINDING

Taxpayer's protest is respectfully denied.

VI. Chemical Containment Dikes – Gross Retail Tax.

DISCUSSION

During the audit period, taxpayer constructed bulk petroleum facilities. In addition, taxpayer upgraded bulk facilities at other locations. The audit report described the plants as "wholesale receiving and distributing facilities for petroleum products." The plants included storage tanks, warehouse, railroad sidings, truck loading racks, and related elements. At issue here are items described as "Bulk Plant Upgrades for Diking."

The Indiana Administrative Code allows manufacturers a sales/use tax exemption for items which are purchased for the purpose of complying with environmental quality standards. 45 IAC 2.2-5-70. Specifically, the regulation provides as follows:

> The state Gross Retail Tax does not apply to sales of tangible personal property which constitutes, is incorporated into, or is consumed in the operation of, a device, facility, or structure predominantly used and acquired for the purpose of complying with any state, local or federal environmental [quality] statutes, regulations or standards; and the person acquiring the property is engaged in the business of manufacturing, processing, refining, mining, or agriculture. 45 IAC 2.2-5-70(a).

The audit report declined taxpayer's invitation to classify as exempt those items used for preparing a "dike" surrounding the bulk petroleum facility. The audit did so because it found that taxpayer was not "engaged in the business of manufacturing, processing, refining, mining, or agriculture." Id.

> Taxpayer has established that the dikes are likely mandated by various regulations requiring the safe containment of fuel spills. However, the rationale for originally denying the exemption remains. As noted above in Part V., the bulk petroleum plant is not "directly engaged in the direct production of a substantially different product," and falls outside the regulation; taxpayer a retailer and wholesalers of petroleum products and is not "engaged in the business of manufacturing, processing, refining, mining, or agriculture." 45 IAC 2.2-5-70(a). Therefore, taxpayer is not entitled to the sales tax exemption set out in 45 IAC 2.2-5-70(a).

As noted in Part V above, taxpayer's petroleum bulk plant is not engaged in the production or processing of "other tangible personal property." IC § 6-2.5-5-3(b). Although the referenced dikes may indeed be mandated by "state, local or federal environmental [quality] statutes, regulations or standards...." because taxpayer is not manufacturing petroleum, it is not entitled to the exemption provided under 45 IAC 2.2-5-70(a).

However, taxpayer raises a secondary consideration. Taxpayer maintains that the dikes are not subject to sales tax because "dikes aren't tangible personal property. In fact they are land improvements. Under Indiana Law, land improvements are exempt from [sales] tax." Taxpayer apparently refers to 45 IAC 2.2-3-8 which states as follows:

> (a) In general, all sales of tangible personal property are taxable, and all sales of real property are not taxable. The conversion of tangible personal property into realty does not relieve the taxpayer from a liability for any owing and unpaid state gross retail tax or use tax with respect to such tangible personal property.
>
> (b) All construction material purchased by a contractor is taxable either at the time of purchase, or if purchased exempt (or otherwise acquired exempt) upon disposition unless the ultimate recipient could have purchased it exempt.

In this case, the audit found that taxpayer had made certain purchases of materials used to construct chemical containment dikes. Assuming for the moment that the assessed materials were incorporated into the construction or fabrication of the containment dikes, the audit correctly found that the materials were subject to use tax. As noted above, "The conversion of tangible personal property into realty does not relieve the taxpayer from a liability for any owing and unpaid state gross retail tax or use tax with respect to such tangible personal property." 45 IAC 2.2-3-8.

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

As noted in Parts I and III, a supplemental audit review will be conducted to determine if the audit's listing of 2007 "total sales" incorrectly included out-of-state sales; the review will also be asked to determine if the 2005, 2006, and 2007 listing of "retail purchases" incorrectly included transactions for tangible personal property not "used" in Indiana. In all other respects, taxpayer's protests are denied.

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