DEPARTMENT OF STATE REVENUE

04-20090027.SLOF

Supplemental Letter of Findings: 09-0027
Sales and Use Tax
For the Years 2005, 2006, and 2007

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 It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register.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. 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; IC § 9-18-2-2; 45 IAC 2.2-3-5; 45 IAC 2.2-4-4; 45 IAC 2.2-5-8; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); Bruns v. Indiana Dep't of State Revenue, 725 N.E.2d 1023 (Ind. Tax. Ct. 2000); Black's Law Dictionary (2d pocket ed. 2001).

Taxpayer protests the imposition of sales and/or use tax on 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 S corporation, conducts custom and specialized machining manufacturing projects for the transportation industry. Taxpayer's products include machinery for farmers and manufacturers as well as race cars. Pursuant to an audit, the Indiana Department of Revenue (Department) assessed sales tax on products which Taxpayer sold to its customers and failed to collect sales tax or to obtain exemption certificates from the customers. The Department's audit also assessed use tax on certain of Taxpayer's purchases because Taxpayer acquired these items without paying sales tax or self-assessing and remitting use tax to the Department. Taxpayer protests the assessments and penalty. After an administrative hearing, the Department issued Letter of Findings 09-0027 (LOF) which sustained Taxpayer's protest in part and denied Taxpayer's protest in part. Taxpayer timely requested a rehearing to present additional documentation. Taxpayer's request was granted, the documentation was reviewed, and this Supplemental Letter of Findings results. Additional facts will be provided as necessary.

I. Sales and Use Tax – Imposition.

DISCUSSION

In its request for rehearing, Taxpayer claimed that the LOF erroneously denied its protest on the Department's assessments of sales/use tax on an oil pump, two computer software support maintenance agreements, and a recreational vehicle (RV). Taxpayer also claimed that it was entitled to manufacturing exemptions on its purchases of tools and equipment, including, but not limited to, a socket set, lights, a vise, air hose reels, because these items were directly used in the direct production.

As a threshold issue, 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).

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.

Accordingly, 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. A statute which provides a tax exemption, however, is strictly construed against the taxpayer. Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96, 97 (Ind. Ct. App. 1974).

A. Manufacturing Exemptions

The Department's audit assessed Taxpayer use tax on its purchases of tools and equipment including a socket set, lights, a vise, hose reels, an AC Power Unit, an electronic meter, and Computerized Numerical Controls (CNC) Software Support Maintenance Agreements because Taxpayer failed to pay sales tax or self-assess and remit to the Department the use tax due. Taxpayer, to the contrary, claimed that it directly used these items in its production process, so it was entitled to the manufacturing exemptions.

IC § 6-2.5-5-3(b) states:

> 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.

IC § 6-2.5-5-5.1(b) provides:

> 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.

An exemption applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. 45 IAC 2.2-5-8(a). 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).

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.

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.

45 IAC 2.2-5-8(g) further states:

> "Have an immediate effect upon the article being produced": Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit. The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced". Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property.

To support its protest, Taxpayer submitted photos and video clips to illustrate its use of the tools and equipment as well as the CNC software. Taxpayer then directed the Department's attention to the following items and believed that manufacturing exemptions were applicable.

1. Tools and Equipment

Taxpayer's documentation has demonstrated to the Department's satisfaction that the socket set, the Angle

Lock Vise, two Air Hose Reels, and the AC Power Unit were directly used in direct production. Thus, Taxpayer was entitled to the manufacturing exemption on these purchases.

Taxpayer's documentation, however, failed to substantiate that the LED Cordless work light, the Magnetic Base light, and the EMF/ELF Electronic Meter were directly used in direct production. The fact that these items 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). Thus, the manufacturing exemptions were not applicable.

The Department will recalculate the assessment in a supplemental audit.

2. Computerized Numerical Controls Software Support Maintenance Agreements

The Department's audit assessed use tax on two CNC Software Support Maintenance Agreements because Taxpayer did not pay sales tax at the time of the purchases nor did Taxpayer self-assess and remit use tax to the Department.

Referring to 45 IAC 2.2-5-8(c), Taxpayer urged the Department to find that Taxpayer was entitled to the manufacturing exemptions on its purchase of the CNC Software Support Maintenance Agreements. Taxpayer claimed that it used the software in its manufacturing process, which "is a machining process that utilized the computer controls which direct the machine to perform milling and cutting operations."

Taxpayer has provided sufficient documentation to show to the Department's satisfaction that it directly used the items in direct production.

In short, Taxpayer was entitled to manufacturing exemptions on its purchases of the socket set, the Angle Lock Vise, two Air Hose Reels, the AC Power Unit, and two CNC Software Support Maintenance Agreements. The Department will recalculate the assessment in a supplemental audit.

B. Resale Exemption

Taxpayer claimed that the LOF erroneously denied Taxpayer's protest on its purchase of the oil pump. The LOF found that the Department's audit assessed use tax on the purchase price of an oil pump, because Taxpayer purchased it without paying sales tax or self-assessing and remitting use tax to the Department. Taxpayer claimed that it purchased the oil pump and resold it to an out-of-state customer. Therefore, pursuant to 45 IAC 2.2-4-4, Taxpayer claimed that it was entitled to the exemption.

Taxpayer has provided sufficient documentation to the Department's satisfaction that it was entitled to the exemption. The Department will recalculate the assessment in a supplemental audit.

C. Nonresident Exemption (Recreational Vehicle)

Taxpayer claimed that the LOF erroneously denied its protest on its RV purchase. The LOF found that Taxpayer's RV was stored in Indiana and Taxpayer's shareholders (operators) who used and enjoyed the RV are Indiana residents with Indiana drivers' licenses. Additionally, the LOF found that the Indiana Bureau of Motor Vehicles (BMV) records showed that this RV traveled to Illinois, Ohio, Kentucky, Missouri, and Tennessee, but never traveled to Montana during the years in question. Since Taxpayer did not pay sales tax, pursuant to IC § 6-2.5-3-2, the LOF concluded that the use tax was properly imposed.

At the rehearing, Taxpayer stated that it had established a non-resident subsidiary company, incorporated in Montana (Montana LLC), through a Montana attorney. The Montana LLC did not have any business purpose other than to hold the title of this RV after the purchase. Specifically, Taxpayer emphasized that the RV was properly registered by this Montana LLC in Montana. Moreover, Taxpayer claimed that it purchased the RV from a third party (Seller), which was also a single member LLC incorporated in Montana through the same arrangement with the same Montana attorney. Thus, referring to IC § 6-2.5-2-1 et seq., Taxpayer argued that the transaction between Taxpayer and Seller, who was not a retail merchant, constituted a "casual sale," which was not subject to Indiana sales tax. Additionally, Taxpayer claimed that its RV purchase was not subject to Indiana use tax. Taxpayer further asserted that, similar to the non-resident plaintiffs in Bruns v. Indiana Dep't of State Revenue, 725 N.E.2d 1023 (Ind. Tax. Ct. 2000), who were not subject to the Indiana tax, its RV was properly registered in Montana by the Montana LLC, so it was not required to register at the Indiana BMV and, therefore, was not subject to Indiana use tax pursuant to 45 IAC 2.2-3-5 and IC § 9-18-2-2.

45 IAC 2.2-3-5(a), in pertinent part, states that "every sale by a resident or nonresident person who is not a retail merchant [] of a vehicle required to be licensed by the state for highway use in Indiana shall be deemed a retail transaction and the use of such vehicle shall be subject to the use tax which shall be paid by the purchaser to the Bureau of Motor Vehicles at the time of the licensing of the vehicle by the purchaser." IC § 9-18-2-2(a), in pertinent part, provides that "a nonresident who owns a vehicle required to be registered under this article may: (1) Operate; or (2) Permit the operation of; the vehicle in Indiana without registering the vehicle or paying any fees if the vehicle is properly registered in the jurisdiction in which the nonresident is a resident."

To support its protest, Taxpayer provided the Department with additional documentation including a copy of Seller's corporate registration with the Montana Secretary of State, a copy of Seller's Articles of Organization (which was also organized by the same Montana attorney), and a letter from the same Montana attorney who orchestrated this "casual sale."

Notably, the Montana attorney, in his letter supporting Taxpayer's protest dated December 01, 2009, stated that Seller and Taxpayer entered into an "oral agreement" to "pay-off the lien by Premier RV Financing, [ ] in the

amount of $175,000, in exchange for the ownership of the motor home" (i.e., the RV). Taxpayer claimed that the purchase and sale agreement of this "$175,000 motor home" was not available because it was an "oral agreement."

Taxpayer is mistaken. The LOF found that IC § 9-18-2-2 refers to "fees" as fees for registration, licensing, etc., and does not include taxes. Since the statute's language clearly distinguishes between a "fee" and "tax," IC § 9-18-2-2 has no bearing on Taxpayer's protest and does not apply to whether or not Taxpayer owes sales or use tax on the purchase of the RV. Additionally, IC § 9-18-2-2(b) states that "[a]n exemption granted to nonresident owners under this section applies only to the extent that Indiana residents are granted exemptions in the jurisdiction that is the residence of the nonresident." Taxpayer did not demonstrate that Montana satisfies the above referenced statutory requirement.

Even if, for the purpose of argument, the Department agreed with Taxpayer that this court in Bruns did conclude that the "fee" in IC § 9-18-2-2 should include "tax," Bruns still does not apply to Taxpayer's situation.

In Bruns, the physician-plaintiff, a bona fide Illinois resident, commuted to and worked full-time in Indianapolis. During weekdays, the physician-plaintiff in Bruns stayed in Indiana and returned to his domicile/residence in Illinois during the weekends. The Bruns court addressed the issues: (1) whether commuters considered as Indiana residents when they commute to work and park at Indiana employers' parking facilities for more than 183 business days are subject to Indiana Motor Vehicle Excise Tax and (2) what constitutes 183 days under Indiana residence statute.

Unlike the physician-plaintiff in Bruns, a bona fide Illinois resident with an Illinois driver's license who traveled between Indiana and Illinois, here, the BMV records showed that Taxpayer's RV never traveled between Indiana and Montana. The BMV records showed that Taxpayer's RV traveled from Indiana to Illinois, Ohio, Kentucky, Missouri, and Tennessee. Unlike the imposition of the Motor Vehicle Excise Tax in Bruns, here, the Department assessed use tax because (1) Taxpayer's RV had been stored in Indiana since it was purchased, (2) Taxpayer is an Indiana S Corporation, and (3) Taxpayer's shareholders (operators) who used the RV are Indiana residents with Indiana drivers' licenses.

A "sham transaction" is defined as "an agreement or exchange that has no independent economic benefit or business purpose and is entered into solely to create a tax advantage." Black's Law Dictionary 643 (2d pocket ed. 2001). The federal and state case law, under the "sham transaction" doctrine, afford the Internal Revenue Service (IRS) and state revenue departments to focus on the substance of taxpayer's arrangement rather than its form.

Taxpayer's alleged "casual sale" was built upon an alleged "oral agreement" between two fictional single member LLCs, which were created by the same Montana attorney, while Taxpayer and its shareholders stored and used the RV in Indiana and enjoyed the federal and state tax benefits.

In this instance, Taxpayer stated that, with the help of the Montana attorney, the Montana LLC was created solely to hold the title of the RV, registered the RV in Montana and nothing more. Taxpayer did not provide any evidence demonstrating that the Montana LLC does any legitimate business in Montana, either. The BMV record showed that the RV was not in and has never been to Montana for those years upon the completion of the alleged "$175,000 oral agreement." In realty, since its purchase, the RV has been in Indiana and where it was used by Taxpayer's Indiana resident shareholders who had Indiana drivers' licenses. While Taxpayer and its shareholders deducted expenses and claimed depreciation on the RV for federal and state income tax purposes, Taxpayer further intended to circumvent the applicable Indiana sales and use tax statutes in the name of the fictional Montana LLC.

Given the totality of circumstances, in the absence of other documentation, the Department is not able to agree with Taxpayer that it has met its burden demonstrating the Department's proposed assessment is wrong. Taxpayer's protest is denied.

FINDING

Taxpayer is entitled to manufacturing exemptions on its purchases of the socket set, the Angle Lock Vise, two Air Hose Reels, the AC Power Unit, and CNC Software Support Maintenance Agreements. Taxpayer is also entitled to the resale exemption on the purchase of oil pump. However, the remainder of Taxpayer's protest is respectfully denied. The Department will recalculate the assessment in a supplemental audit.

II. Tax Administration – Penalty.

DISCUSSION

Taxpayer also protests the imposition 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 did not provide sufficient documentation establishing that its failure to timely remit tax was due to reasonable cause and not due to negligence.

FINDING

Taxpayer's protest on the imposition of the negligence penalty is denied.

SUMMARY

For the reasons discussed above, Taxpayer's protest in Part I is sustained in part and denied in part. Taxpayer's protest on the imposition of negligence penalty is respectfully denied. The Department will recalculate the assessment in a supplemental audit.

Posted: 04/28/2010 by Legislative Services Agency
An html version of this document.