DEPARTMENT OF STATE REVENUE

04-20090321.LOF

Letter of Findings: 09-0321
Gross Retail Tax
For the Years 2005, 2006, and 2007

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ISSUES

I. Public Transportation Exemption – Sales and Use Tax.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-2(a); IC § 6-2.5-5-27; IC § 6-8.1-5-1(c); Park 100 Dev. Co. v. Indiana Dept. of State Rev., 429 N.E.2d 220 (Ind. 1981); Carnahan Grain, Inc. v. Indiana Dep't of State Revenue, 828 N.E.2d 465 (Ind. Tax Ct. 2005); Panhandle Eastern Pipeline Co. v. Indiana Dept. of State Rev., 741 N.E.2d 816 (Ind. Tax Ct. 2001); Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Indiana Dept. of State Rev. v. Kroger Co., 453 N.E.2d 1175 (Ind. Ct. App. 1983); Reynolds Metals Co. v. Indiana Dept. of State Rev., 433 N.E.2d 1 (Ind. Ct. App. 1982); Indiana Dept. of State Rev. v. Marsh Supermarkets, 412 N.E.2d 261 (Ind. Ct. App. 1980); Meridian Mortgage, Inc., v. State, 395 N.E.2d 433 (Ind. Ct. App. 1980); 45 IAC 2.2-5-61.

Taxpayer objects to the imposition of sales or use tax on a variety of transportation equipment purchases.

II. Sampling Adjustments – Sales and Use Tax.

Authority: IC § 6-2.5-8-8(a); IC § 6-8.1-3-12(b).

Taxpayer asks that the Department adjust the sampling methodology used by the audit to determine Taxpayer's additional sales and use tax liability.

III. Administration – Ten Percent Negligence Penalty.

Authority: IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(a)(4); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer asks that the Department exercise its authority to abate the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is in the business of providing transportation services to a related entity hereinafter designated as "Parent." Parent is in the business of selling fuel to retail customers located both within Indiana and outside Indiana. In addition to its retail operation, Parent also operates a fuel storage business and provides fuel related services to its customers.

The Department of Revenue (Department) conducted an audit review of Taxpayer's business and tax records concluding that Taxpayer owed additional sales and use tax. Taxpayer disagreed with certain of the audit's original conclusions and submitted a protest to that effect. An administrative hearing was held during which Taxpayer's representatives explained the basis for the protest. Subsequent to that hearing, Taxpayer submitted additional information intended to buttress Taxpayer's objections. This Letter of Findings results.

I. Public Transportation Exemption – Sales and Use Tax.

DISCUSSION

An original audit report was completed in January 2009 assessing Taxpayer additional sales and use tax. The report found that Taxpayer purchased items for which Taxpayer had not paid sales tax and failed to self-assess use tax. Taxpayer argues that the audit overstates its sales and use tax liability because it is entitled to the "public transportation" sales tax exemption.

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."

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). A complementary 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. IC § 6-2.5-3-2.

Specifically, IC § 6-2.5-2-1 provides as follows:

(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(a) provides for the complementary use tax:

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.

Taxpayer maintains that because it provides fuel transportation services for its Parent, Taxpayer's transportation equipment qualifies for the public transportation exemption. The exemption sought is found at IC § 6-2.5-5-27, which states:

Transactions involving tangible personal property and services are exempt from the state gross retail tax, if the person acquiring the property or service directly uses or consumes it in providing public transportation for persons or property.

45 IAC 2.2-5-61 is also pertinent. That regulation states in relevant part:

(a) The state gross retail tax shall not apply to the sale and storage or use in this state of tangible personal property which is directly used in the rendering of public transportation of persons or property.

(b) Definition: Public Transportation. Public transportation shall mean and include the movement, transportation, or carrying of persons and/or property for consideration by a common carrier, contract carrier, household goods carrier, carriers of exempt commodities, and other specialized carriers performing public transportation service for compensation by highway, rail, air, or water, which carriers operate under authority issued by, or are specifically exempt by statute or regulation from economic regulation of, the public service commission of Indiana, the Interstate Commerce Commission, the aeronautics commission of Indiana, the U.S. Civil Aeronautics Board, the U.S. Department of Transportation, or the Federal Maritime Commissioner; however, the fact that a company possesses a permit or authority issued by the P.S.C.I., I.C.C., etc., does not of itself mean that such a company is engaged in public transportation unless it is in fact engaged in the transportation of persons or property for consideration as defined above.

(c) In order to qualify for exemption, the tangible personal property must be reasonably necessary to the rendering of public transportation. The tangible personal property must be indispensable and essential in directly transporting persons or property.

. . ..

The Indiana Tax Court has addressed the application of the public transportation exemption. In Carnahan Grain, Inc. v. Indiana Dep't of State Revenue, 828 N.E.2d 465, 468 (Ind. Tax Ct. 2005) the court stated:

[I]f the property is not predominately used for third-party transportation (i.e., it is predominantly used to transport the taxpayer's own property), then the taxpayer is not entitled to the exemption.

The Tax Court has held that the transportation exemption may not be used to prorate a taxpayer's liability. Panhandle Eastern Pipeline Co. v. Indiana Dept. of State Rev., 741 N.E.2d 816, 818-19 (Ind. Tax Ct. 2001). Rather, the court has held that the transportation exemption "is an all or nothing exemption." Id. at 819. "If a taxpayer acquires tangible personal property for predominate use in providing public transportation for third parties, then it is entitled to the exemption. If a taxpayer is not predominately engaged in transporting the property of another, it is not entitled to the exemption." Id.

In summary, in order to qualify for the public transportation exemption, Taxpayer must show that the equipment purchased was predominantly used to transport the property of a third party for which the Taxpayer received consideration.

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

In order to qualify for the exemption it seeks, Taxpayer must demonstrate that its business existence is distinct from that of the parent; if the Taxpayer and Parent treat their business operations as a single, unitary, blended operation, then it becomes difficult for Taxpayer to demonstrate to that it – standing alone – is predominately engaged in public transportation and that is providing that transportation service to a third-party.

The question of whether Taxpayer was entitled to the public transportation exemption was first addressed by the Department in June 2009 some six months following the date on which the original audit report was issued because the issue was never raised during the pendency of the original audit report. As explained in a June 2009 "Memorandum," "The taxpayer is protesting the assessment of sales tax on transportation purchases claiming there is a separate transportation company which is exempt. The [January 2009] audit report does not explain anything about this issue or the transportation purchases."

The June Memorandum found that, "[B]eyond the formation of [Taxpayer] there were no separate records maintained for [Taxpayer] that supported 'arm's length' transactions between the entities." At the time the supplemental Memorandum was prepared, "The taxpayer was requested to provide additional information to support the protest."

The supplemental Memorandum found that Taxpayer – the transportation entity – did not pay for the trucks, or "any equipment, repairs, fuel, etc." and that there was no indication that Taxpayer reimbursed Parent for any of the vehicle, equipment, fuel, or other expenses.

In order to support its claim that Taxpayer functioned as a separate, independent entity, Taxpayer provided a bank statement which indicated that Taxpayer maintained an account separate from that of the Parent. However, the bank statement provided was outside the audit period and simply indicated that the account had an opening

balance of $1,000 and a closing balance of $1,000. The bank statement did not establish that Taxpayer billed or invoiced the Parent for the services provided.

Taxpayer did provide the audit with a "Transportation Agreement" between itself and Parent. The Agreement was signed on behalf of Taxpayer and Parent but indicated that the same person signed as president for both entities. The Agreement purported to establish a methodology by which Taxpayer's expenses would be billed to Parent based on a fixed markup of Taxpayer's actual costs. However, "[T]axpayer did not provide documentation to substantiate that transactions had in fact taken place between [Taxpayer] and [Parent]."

Taxpayer also provided a "Driver Leasing Agreement" between Taxpayer and Parent. As with the aforementioned "Transportation Agreement," the "Driver Leasing Agreement" was signed by the same person acting as president for both Taxpayer and Parent. The "Driver Leasing Agreement" indicated that Parent would compensate Taxpayer for expenses related to the labor expenses incurred by Taxpayer although the parties agreed that "such fees [could] be offset against any monies owed by [Taxpayer] to [Parent]." However, Taxpayer did not provide documentation to "establish that these transactions had in fact taken place between [Taxpayer] and [Parent]."

The June 2009 Memorandum indicates that "no documentation [was] provided to prove that separate books and records were maintained by [Taxpayer]." The audit also reviewed Taxpayer's Indiana income tax returns but found "no schedules reflecting all income and expenses with appropriate inter-/intra- company eliminations." A review of those returns also found "no separate depreciations schedules for [Taxpayer] and [Parent]."

Based on the information provided and noted here above, the June 2009 Memorandum did not agree with Taxpayer's belated assertion that it was entitled to claim the transportation exemption.

During the course of the administrative hearing, Taxpayer produced documents and information purporting to establish that the Taxpayer's business operations were distinct from and operated in an arms-length fashion from Parent. Taxpayer provided a copy of its organizational structure intended to establish that Parent and Taxpayer were separate entities.

Taxpayer also challenged the audit's criticism of the lack of separate financial records for Taxpayer and Parent. Taxpayer maintains that under Indiana law, IC § 6-2.5-10-2, "[D]etailed general ledgers and/or depreciation schedules are not required and have no legal impact on [Taxpayer's] for-hire motor carrier status under Indiana sales and use tax law." Taxpayer states that requiring Taxpayer and Parent to maintain "detailed records is an extra step that is not required by the law." Taxpayer also argues that it is not required to issue Parent invoices as evidence that Taxpayer and Parent maintain a separate, distinct existence. Taxpayer states that it "did not issue transportation invoices because they are not required, whether serving an affiliated shipper or not, and this request has no bearing on its status as for-hire motor carrier under Indiana sales and use tax law."

On the question of whether Taxpayer was compensated for labor costs incurred in transporting Parent's fuel, Taxpayer indicates that, "As the entity with legal control over the leased drivers, [Taxpayer's] use of leased drivers, which are obtained from [Parent] is not germane to the question of for-hire carrier status and driver leasing has no legal impact upon a motor carrier's for-hire status under Indiana sales tax law."

The Department does not disagree with Taxpayer that it is a valid "for-hire carrier" fully licensed and authorized to provide transportation services nor does it disagree with Taxpayer's explanation that Taxpayer was formed – in part – as a means of isolating Parent from unexpected insurance claims or claims based on Taxpayer's potential negligence. The issue is whether Taxpayer is "predominately engaged" in providing public transportation and on this narrow issue the Department is unable to agree with Taxpayer that it is entitled to the exemption for the following reasons.

The first reason is that the audit's original determination is not to be lightly overturned because the auditor was in the best position to review the original source documentation and to make a reasoned determination based on that documentation. Under IC § 6-8.1-5-1(c), it is Taxpayer which bears the "burden of proving that the proposed assessment is wrong...." Despite Taxpayer's diligent efforts, the Department is unable to agree that Taxpayer has proven that the original assessment assertion was wrong.

The second reason is that the transportation exemption sought – as with all other sales tax exemptions – is " strictly construed in favor of taxation and against the exemption." Kimball Int'l Inc., 520 N.E.2d at 456. (Emphasis added). In order to sustain Taxpayer's protest, the Department would be required to gloss over or totally ignore the substantive evidence that the distinction between Taxpayer and its Parent is – to a large degree – something of a formality and that in many respects that is little practical difference between the two entities.

The third reason is that Indiana courts have repeatedly emphasized that, for Indiana tax purposes, the taxability of a transaction is to be measured by its substance – not its form – when applying the governing Indiana tax laws: Park 100 Dev. Co. v. Indiana Dept. of State Rev., 429 N.E.2d 220 (Ind. 1981); Indiana Dept. of State Rev. v. Kroger Co., 453 N.E.2d 1175 (Ind. Ct. App. 1983); Reynolds Metals Co. v. Indiana Dept. of State Rev., 433 N.E.2d 1 (Ind. Ct. App. 1982); Indiana Dept. of State Rev. v. Marsh Supermarkets, 412 N.E.2d 261 (Ind. Ct. App. 1980); Meridian Mortgage, Inc., v. State of Indiana, 395 N.E.2d 433 (Ind. Ct. App. 1980).

To conclude that Taxpayer and Parent maintained a separate, independent, arm's-length relationship, the Department would necessarily "hold that form triumphs over substance..." and this the Department cannot do. Park 100 Dev. 429 N.E.2d at 223. Taxpayer is not entitled to the exemption because it is not predominately

engaged in providing public transportation; Taxpayer provides a private transportation service for its Parent.

FINDING

Taxpayer's protest respectfully denied.

II. Sampling Adjustments – Sales and Use Tax.

DISCUSSION

Taxpayer believes that the "error percentage" determined by the audit by means of a sampling methodology should be adjusted. As determined by the audit, the "sales tax error factor" is 1.4888 percent; Taxpayer believes that after making the proposed adjustments, the "sales tax error factor" should be decreased to 0.5979 percent.

IC § 6-8.1-3-12(b) allows, as follows, the Department to employ a sampling methodology in determining a taxpayer's liability:

> The department may audit any returns with respect to the listed taxes using statistical sampling. If the taxpayer and the department agree to a sampling method to be used, the sampling method is binding on the taxpayer and the department in determining the total amount of additional tax due or amounts to be refunded.

The audit report described the reasons for choosing a sampling methodology as follows:

> 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.

Having determined that a sampling methodology was both warranted and agreed to by the Taxpayer, "A 'pull list' was developed using the methodology described in the projection and the accompanying memo to determine the sales invoices that were reviewed for the projection...."

After reviewing the sample invoices, "An error percentage was then applied to the total sales by year for 2006 and 2007 that were provided by the taxpayer to arrive at projected additional sales by year." However, "Because the taxpayer was unable to provide total sales data for the 2005 year, it was agreed to by the taxpayer and the Department to calculate and arrive at an estimated amount of '2005 Total Sales'...."

Taxpayer asks that the Department belatedly accept four additional "exemption certificates" in order to establish that it was not required to collect sales tax from those entities. IC § 6-2.5-8-8(a) states:

> A person, authorized under subsection (b), who makes a purchase in a transaction which is exempt from the state gross retail and use taxes, may issue an exemption certificate to the seller instead of paying the tax. The person shall issue the certificate on forms and in the manner prescribed by the department. A seller accepting a proper exemption certificate under this section has no duty to collect or remit the state gross retail or use tax on that purchase.

The audit division is requested to review the exemption certificates and – assuming that the certificates have been submitted "in the matter prescribed by the department" – adjust the "error percentage" and the assessment amount as warranted.

In addition, Taxpayer has submitted invoices for three named customers which were included in the "sales tax error factor" because Taxpayer failed to charge the customers sales tax at the time of the original transactions. After the audit was completed, Taxpayer billed those three named customers for the uncollected sales tax. Having done so, Taxpayer believes that the three named customers should now be removed from the "sales tax error factor" because – however belatedly – Taxpayer rectified the error and collected the tax.

Taxpayer somewhat misses the point. In this case, the issue was not whether or not sales tax was eventually collected from these three named customers but whether – at the time the audit was performed – the audit erred by including these entities in the "error factor." At the time the audit was conducted, the original invoices indicated that Taxpayer did in fact make a billing error and failed to collect sales tax. Can a taxpayer retroactively correct an error and then have that correction alter the sampling result? The answer is no; once a true and accurate sampling has been completed, that sample stands unless the sample was based on erroneous information.

FINDING

Taxpayer's protest is sustained in part and denied in part. The audit division is requested to review the four exemption certificates and make whatever adjustments it deems appropriate. However, no adjustment will be made to the "error percentage" based on the premise that Taxpayer belatedly collected sales tax from the three named customers.

III. Administration – Ten Percent Negligence Penalty.

DISCUSSION

Taxpayer believes that it is entitled to abatement of the ten-percent negligence penalty under the statutory "reasonable cause" standard. According to the "Audit Progress Report," the penalty was imposed because "taxpayer's sales records revealed sales to customers made free of sales tax without proof of exempt usage," and because Taxpayer had not "remitted the gross retail tax due the [Department] on their taxable purchases from out-of-state vendors and Indiana vendors when the vendor did not collect the Indiana sales tax."

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(4) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that

the failure to... pay the full amount of tax shown on the person's return... or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty." (Emphasis added).

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that 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 IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment – including the negligence penalty – is presumptively valid.

Based on a "case-by-case" analysis and after reviewing "the facts and circumstances of each taxpayer" the Department agrees that the ten-percent negligence penalty should be abated.

FINDING

Taxpayer's protest is sustained.

SUMMARY

The audit division is requested to review the four additional exemption certificates provided by Taxpayer and to adjust the amount of tax assessed as warranted. The Department will abate the ten-percent negligence penalty. In all other respects, Taxpayer's protest is denied.

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