DEPARTMENT OF STATE REVENUE

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Letter of Findings: 09-0957
Sales and Use Tax
For the Years 2006, 2007, 2008

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ISSUES

I. Sales and Use Tax – Public Transportation Exemption.

Authority: IC § 6-8.1-5-1; IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-5-27; 45 IAC 2.2-5-61; Sales Tax Information Bulletin 12 (July 2010); State Dep't of Revenue v. Calcar Quarries, Inc., 394 N.E.2d 939 (Ind. Ct. App. 1979); National Serv-All, Inc. v. Indiana Dep't of State Revenue, 644 N.E.2d 954 (Ind. Tax Ct. 1994); Indiana Waste Systems of Indiana, Inc. v. Indiana Dep't of State Revenue, 644 N.E.2d 960 (Ind. Tax Ct. 1994); Panhandle Eastern Pipeline Co. v. Indiana Dep't of State Revenue, 741 N.E.2d 816 (Ind. Tax Ct. 2001); Carnahan Grain, Inc. v. Indiana Dep't of State Revenue, 828 N.E.2d 465 (Ind. Tax Ct. 2005); Indiana Dept. of State Rev. v. Kimball Int'l, 520 N.E.2d 454 (Ind. Ct. App. 1988).

Taxpayer protests the imposition of use tax on a variety of transportation equipment purchases.

II. Tax Administration – Negligence 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 is an Indiana company organized as a single member LLC. Taxpayer's single member, also an Indiana company, is a wholesale food distributor ("Distributor"). Taxpayer is a general freight company that primarily hauls Distributor's products. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer for the years 2006, 2007, and 2008, where 2007 purchases, other than those of fixed assets, were projected to the other years of the audit. The Department's audit found that Taxpayer had not paid sales tax on certain purchases and had not remitted use tax upon use of the items including vehicles, vehicle repair parts, tires, and fuel purchases, etc. and assessed Taxpayer additional use tax, penalty, and interest. Taxpayer protested the assessment on the basis that the purchase of these items qualified for the public transportation exemption from sales and use tax. A hearing was held and this Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Public Transportation Exemption.

DISCUSSION

The Department's audit found that Taxpayer purchased items including vehicles, vehicle repair parts, tires, and fuel purchases, etc., for which Taxpayer had not paid sales tax and for which Taxpayer had failed to self-assess use tax. Taxpayer argues that the Department incorrectly assessed use tax because it is entitled to the "public transportation" sales and use 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.

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 elaborates on the public transportation exemption. The 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.

Indiana courts have interpreted the public transportation exemption in a series of cases including State Dep't of Revenue v. Calcar Quarries, Inc., 394 N.E.2d 939 (Ind. Ct. App. 1979) (holding that the tangible personal property being transported must be the property of another); National Serv-All, Inc. v. Indiana Dep't of State Revenue, 644 N.E.2d 954 (Ind. Tax Ct. 1994) (holding that to be entitled to the public transportation exemption, a carrier must transport tangible personal property of another and for consideration); Indiana Waste Systems of Indiana, Inc. v. Indiana Dep't of State Revenue, 644 N.E.2d 960 (Ind. Tax Ct. 1994) (holding that a taxpayer must use the tangible personal property predominately in public transportation in order to qualify for the exemption) (" Indiana Waste Systems II"); Panhandle Eastern Pipeline Co. v. Indiana Dep't of State Revenue, 741 N.E.2d 816 (Ind. Tax Ct. 2001) (holding that the public transportation predominant use exemption is an all or nothing exemption); Carnahan Grain, Inc. v. Indiana Dep't of State Revenue, 828 N.E.2d 465 (Ind. Tax Ct. 2005) (holding that it is the predominant use of the property that determines whether a taxpayer involved in multiple lines of business is entitled to the public transportation exemption, and not whether a taxpayer, as an overall business, is predominately engaged in public transportation).

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 another 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).

Taxpayer argues that it has demonstrated that during the audit years it operated as a for-hire motor carrier because it transported cargo owned by others (Distributor and unrelated third parties) for consideration (as evidenced by the intercompany transfers and additional income from the backhauls) one-hundred percent of the time (thus satisfying the predominant use requirement) in its trucking operations. Taxpayer maintains, therefore, that its transportation equipment purchases qualify for the public transportation exemption.

After the audit period, The Department released Sales Tax Information Bulletin 12 (July 2010) (replacing an earlier version dated December 2009) which sets out the factors the Department will weigh in determining whether a transportation company qualified for the sales and use tax public transportation exemption. While the revised information bulletin was not in effect during the audit years, a review of the factors stated in the revised bulletin is useful. Some of the factors are more critical to the determination than others:

II. Public Transportation Requirements

The following requirements are factors the Department weighs in determining whether a transportation company is engaged in public transportation. An asterisk (*) indicates a requirement that is considered by the Department to be a critical factor in determining whether a transportation company qualifies for the public transportation exemption. A transportation company fails to qualify for the exemption if it does not, at a minimum, adhere to all the critical requirements. However, failure to adhere to one or more of the "noncritical" requirements can also result in a transportation company's failure to qualify for the exemption. The requirements are:

- The transportation company must transport the persons or property of another.*
- The transportation company must maintain all shipping/transporting documents for all transactions (e.g., trip reports, truck logs, and invoices).*
- The transportation company must receive compensation for the services it provides.*
- The transportation company must hold and pay for appropriate public transportation insurance.*
- The transportation company must be fully and independently authorized by federal and/or state authorities to provide public transportation services.*

- If an employee of the parent company performs duties for the parent company and also performs "leased" duties for the transportation company, the parent company must maintain detailed records of when and what duties that employee is performing for the parent company and when and what duties that employee is performing under the lease.*
- If the parent company makes a capital contribution of the vehicles to the transportation company, titles to the vehicles must be transferred to the transportation company.*
- The transportation company and the parent company must maintain separate books and records, including separate charts of accounts for each company.
  - Transactions between the parent company and the transportation company must evidence a commercially reasonable, arms-length relationship between the parties.
  - Transactions between the parent company and the transportation company must be evidenced by actual invoicing and payments for all transactions.*
  - The parent company and the transportation company must segregate and account for each entity's purchases and expenses.*
  - The parent company and the transportation company must maintain separate bank accounts.
  - The parent company and the transportation company must issue separate W2 forms to their employees.
  - The parent company and the transportation company must maintain separate federal depreciation schedules pursuant to generally accepted accounting standards.
  - Any income earned by the transportation company for transporting for a third party is to be recognized by the transportation company.
  - Because the transportation company and the parent company must have a distinct, arms-length business relationship, their separate incomes and expenses must be reflected on the taxpayers' federal income tax filings, all of which must be reconciled with the taxpayers' own records; when transactions are eliminated as intercompany transactions, the taxpayers must file the appropriate schedules with their federal returns.*
- If the parent company owns and holds titles to the vehicles, the parent company may lease those vehicles to the transportation company. However:
  - The lease must be documented as a commercially reasonable, arms-length transaction; and
  - The lease must be evidenced by actual payments to the parent company.
- If the transportation company owns the vehicles, titles to the vehicles must be held by the transportation company.
- The parent company and transportation company must have separate employees, or, if the transportation company leases its employees from the parent company, there must be a meaningful, arms-length charge for the leased employees.

During the audit and at the hearing Taxpayer provided documentation demonstrating that it had full federal and state interstate and intrastate operating authority and that it had appropriate public liability and cargo insurance. Subsequent to the hearing, Taxpayer provided documentation showing intercompany transfers from Distributor to Taxpayer compensating Taxpayer for its transportation expenses. Taxpayer also demonstrated that it retained the backhauling income. Taxpayer owned and retained title to all the transportation vehicles. Taxpayer had separate accounts and maintained its own books and records.

While Taxpayer does not meet every required factor according to Sales Tax Information Bulletin 12, on balance Taxpayer has sufficiently demonstrated that it qualifies for the public transportation sales tax exemption. The balance tips in Taxpayer's favor in this instance in light of the fact that Taxpayer did not have prior notice of the Department's recently released requirements at the time of this audit. However, Taxpayer (and its single member, Distributor) should note that going forward it should conform its business practices to the requirements now set out clearly by the Department in Information Bulletin 12 as referenced above.

FINDING

Taxpayer's protest is sustained.

II. Tax Administration – Negligence Penalty.

DISCUSSION

The Taxpayer also protested the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> 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 standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) 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.

Since Taxpayer has been sustained on its qualification for the public transportation exemption, the negligence penalty is also removed.

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer's protest of both the assessment of use tax and penalty are sustained.

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