DEPARTMENT OF STATE REVENUE

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Letter of Findings: 09-0400
Gross Retail Tax
For the Years 2005, 2006, and 2007

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ISSUES

I. Sales and Use Tax – Manufacturing Exemption.

Authority: IC § 6-2.5-5-3; IC § 6-8.1-5-1; General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991).

Taxpayer argues it is entitled to claim the "manufacturing exemption" and was not required to pay sales on the purchase of certain tangible personal property.

II. Sales and Use Tax – Public Transportation Exemption.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-5-8; IC § 6-2.5-5-27; 45 IAC 2.2-5-61; Sales Tax Information Bulletin 12 (July 1, 2010) (20100623 Ind. Reg. 045100390NRA); Kimball Int'l Inc. v. Indiana Dep't of Revenue, 520 N.E.2d 454, 456 (Ind. Ct. of App. 1988).

Taxpayer maintains that it was not required to pay sales or use tax on the purchase of the tangible personal property because it is engaged in "public transportation."

III. Tax 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 protests the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a "warehousing and freight" business located in Indiana. The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business, tax, and financial records for the years 2005, 2006, and 2007. The Department concluded that Taxpayer owed sales/use tax and issued assessments to that effect. Taxpayer submitted a protest challenging the Department's assessment. An administrative hearing was conducted and this Letter of Findings Results. Additional facts will be provided as necessary.

I. Sales and Use Tax – Manufacturing Exemption.

DISCUSSION

Taxpayer operates several large warehouses which are located in close proximity to an Indiana manufacturer. This particular manufacturer is a primary customer of Taxpayer. Taxpayer has a contract with the primary customer – and a number of other small businesses – to provide supply chain management including distribution, inventory management, order fulfillment, carrier management, export packaging, containerization, warehousing and storage (as described on one of Taxpayer's affiliate websites).

In the case of the primary customer, Taxpayer receives customer's finished goods. The finished goods have been largely prepared for shipment at the time they arrive at Taxpayer's location. The finished goods arrive at one of Taxpayer's warehouses on skids. Taxpayer warehouses the goods which are – on occasion – shrink wrapped or crated by Taxpayer. On other occasions, Taxpayer "lag bolts" the finished goods to the skids. Taxpayer eventually weighs the goods, processes the shipping documentation, and arranges for a third-party to deliver the goods to the eventual recipient.

Taxpayer maintains that the sales/use tax assessment was incorrect because Taxpayer believes it is largely exempt from sales/use tax on the rationale that it is continuing its primary customer's manufacturing process. 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's initial argument is described in the audit report as follows:

> It is the taxpayer's contention that they are an extension of [primary customer] and are therefore a continuation of the production process. The Taxpayer believes that they are part of the production process and therefore, exempt from sales or use tax. [Taxpayer has] provided exemption certificates to nearly all of their vendors for purchases of tangible personal property.

Taxpayer relies on IC § 6-2.5-5-3(b) which states in relevant part that "[t]ransactions 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." The issue of whether two or more business locations can function as a integrated production process, entitling both locations to the manufacturing exemption,

was addressed by the Indiana Tax Court in General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991) aff'd 599 N.E.2d 588 (Ind. 1992).

In General Motors, the automobile manufacturer shipped component automobile parts to its plants and claimed an exemption for the purchase of items employed in the interdivisional transfer of those component parts on the ground that the automobile manufacturer operated a continuous manufacturing process which only ended at the point where the finished automobiles were shipped to its dealerships.

The court held that the automobile manufacturer's individual manufacturing facilities were part of an integrated process whereby the manufacturer produced its finished product. Therefore, the automobile manufacturer's packing materials were exempt under IC 6-2.5-5-3. The court reached that decision after finding the automobile manufacturer's widely separated production facilities formed a cohesive, singular production unit in which the claimant's "manufacture of finished marketable automobiles [was] accomplished by one continuous integrated production process within which the transport of parts from component plants to assembly plants [was] an essential and integral part." General Motors, 578 N.E.2d at 404.

In finding that the automobile manufacturer's production process encompassed manufacturing activities performed at multiple sites, the court identified a number of significant facts. Specifically, the court found that "[t]he facts in the case as well as previous judicial findings indicate GM's production process is by nature highly integrated. The court's sole concern, however, is whether GM's manufacturer of finished automobiles qualifies as one continuous integrated production process for the purpose of exemption from sales/use tax." Id. at 402.

Footnote three gives some indication of the evidence which the court relied in arriving at a conclusion that GM's production was both "continuous" and "integrated." Specifically, the court found that "GM's component plant personnel collaborate with the assembly plant personnel (1) to develop new product concepts, (2) to individually design, engineer, and test the performance of new parts and packing materials, (3) to plan the layout and production processes for new parts, (4) to coordinate production schedules because delays at one plant would have an immediate effect on the other plants, and (5) to solve problems and ensure quality control." Id. at 402 n.3. In addition, the court noted that a "continuity of production exists between GM's different plants [which is] demonstrated by the standard practice of shifting certain production operations back and forth between component and assembly plants when necessary for more efficient operation." Id.

It was in the context of these particularized facts and findings that the court held that GM's manufacture of automobiles represented one "continuous integrated production process." Id. at 404. It was in the context of these particularized facts and findings that the court held that GM's assembled automobiles, and not the automobile's component parts, constituted the taxpayer's most marketable product and that the production of that "most marketable product" constituted the conclusion of GM's integrated but physically discontinuous manufacturing process. In other words, the tangible personal property that traveled between plants was work-in-process until the "most marketable product" was completed.

Taxpayer maintains that it is simply an extension of its customer's manufacturing process and that is simply completing a process begun at its customer's manufacturing plant. Taxpayer explains that it conducts activities which "were once part of [customer's] manufacturing process."

The Department must decline the opportunity to expand the holding in General Motors beyond the unique factual setting found in that particular case. As the General Motors court itself noted, "[t]he equipment exemption must be interpreted adhering to the rule that ambiguous exemption statutes must be strictly construed in favor of imposing tax and against the taxpayer. The taxpayer claiming exemption has the burden of showing the terms of the exemption statute are met." Id. at 404 (Internal citations omitted). Additionally, "[e]xemption statutes are strictly construed because an exemption releases property from the obligation of bearing its fair share of the cost of government." Id. Taxpayer's primary customer manufacturers certain goods and arranges for those goods to be delivered to one of the Taxpayer's warehouse facilities after the manufacturing process is completed. Taxpayer then arranges for those goods to be delivered to the ultimate destination. Taxpayer provides warehousing and shipping services to its primary customer and is not a manufacturer.

FINDING

Taxpayer's protest is respectfully denied.

II. Sales and Use Tax – Public Transportation Exemption.

DISCUSSION

Taxpayer argues that it is entitled to the "transportation exemption" and was not required to pay sales tax – or self-assess use tax – on the purchase of certain tangible personal property citied *[sic]* in the Department's audit report. Taxpayer points out that it "has always considered itself a transportation provider because it generates a large amount of shuttle freight revenue per year from [primary customer] and a few other customers." In addition, Taxpayer notes that it has a "Federal Highway Administration Permit," has a certificate as a "Common Carrier of Household Goods," and that Indiana has issued it a certificate for the "movement of Household Goods between all points in Indiana." Further, Taxpayer indicates that it has maintained its Federal Motor Carrier Safety Administration "Common, Contract and Broker Authority Status."

As noted previously, Indiana imposes a gross retail (sales) tax on retail transactions in Indiana. IC § 6-2.5-2-1. The legislature has provided a number of exemptions to the imposition of that tax. See IC § 6-2.5-5-1 to

-40. One of those exemptions is provided at IC § 6-2.5-5-8 which states that, "Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of his business without changing the form of the property."

However, Indiana law allows a sales tax exemption for tangible personal property acquired and used in "public transportation." IC § 6-2.5-5-27 states that, "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."

The Department has promulgated a regulation, 45 IAC 2.2-5-61(b), relevant to Taxpayers' circumstances. The regulation states:

> 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. (Emphasis added).

Taxpayer is not entitled to the exemption it seeks because it is not in the business of transporting tangible personal property; Taxpayer is a warehousing facility which arranges for the transportation of its customers' goods by third-parties. Taxpayer may be an important link in transporting those goods, but the actual "public transportation" of its customers' goods is accomplished by others.

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. v. Indiana Dep't of Revenue, 520 N.E.2d 454, 456 (Ind. Ct. of App. 1988). (Emphasis added). In order to sustain Taxpayer's protest, the Department would be required to gloss over the fact that the delivery of its customers' goods is accomplished by others; as explained by Taxpayer, it "contracted with a transportation company to pull [Taxpayer's] leased trailers and deliver the load as directed by [Taxpayer]." Taxpayer is directed to the Department's most current Sales Tax Information Bulletin 12 (July 1, 2010) (20100623 Ind. Reg. 045100390NRA) for further guidance as the requirements, some of which are critical requirements, to qualify for the public transportation exemption.

FINDING

Taxpayer's protest is respectfully denied.

III. Tax Administration – Ten-Percent Negligence Penalty.

DISCUSSION

Taxpayer protests the assessment of the ten-percent negligence penalty.

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."

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.

The Department believes that Taxpayer erred in determining its sales and use tax liability and in its assertion that it was entitled to either the "public transportation" or the "manufacturing" exemption. While Taxpayer's position is incorrect, there is insufficient information to establish that Taxpayer's position was so egregious as to constitute "willful neglect." 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.

CONCLUSION

Taxpayer's protest that it does not owe the tax assessed through the audit because it is qualifies for manufacturing exemptions is denied.

Taxpayer's protest that it does not owe the tax assessed through the audit because it qualifies for the public transportation exemption is denied.

Taxpayer's protest of the assessment of the negligence penalty is sustained.

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