

**Supplemental Letter of Findings: 04-20110024**  
**Sales and Use Tax**  
**For Tax Years 2006, 2007, and 2008**

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**ISSUES**

**I. Sales and Use Tax – Food and Food Ingredients.**

**Authority:** Sales Tax Information Bulletin 29 (August 2008); Sales Tax Information Bulletin 29 (July 2005); Letter of Findings 04-20110024 (November 2, 2011).

Retail Merchant protests the assessment of sales tax on certain items it believes are non-taxable as food items.

**II. Sales and Use Tax – Manufacturing Exemption – Credit For Tax Paid.**

**Authority:** IC § 6-2.5-5-3; IC § 6-2.5-5-4; IC § 6-2.5-5-5.1; IC § 6-2.5-5-6.

Retail Merchant protests the Department's denial of a credit for sales tax paid on certain purchases of items it claims are either consumed or used in its photo processing operation; Retail Merchant argues that the items were subject to the manufacturing exemptions.

**STATEMENT OF FACTS**

Retail Merchant operates the Indiana retail locations of a national drugstore chain. Protestant, hereinafter referred to as "Retail Merchant," collects sales tax on behalf of the state on the taxable items Retail Merchant sells to its customers who pay the sales tax. Retail Merchant is itself a taxpayer when it purchases tangible personal property for use in its own operations.

The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Retail Merchant for the years 2006, 2007, and 2008. As a result of the audit, Retail Merchant was assessed additional sales and use tax, as well as penalty and interest. The Department found that Retail Merchant had not collected sales tax from its customers on the sale of certain grocery items and therefore the Department assessed Retail Merchant for the uncollected sales tax. Retail Merchant protests these assessments. Also, Retail Merchant protests that it was not given credit for sales tax it claims it erroneously paid on its purchase of equipment and supplies used in its photo processing operation. A hearing was held on Retail Merchant's protest. After the hearing, Retail Merchant withdrew its protest of certain issues in a letter dated May 19, 2011, namely "construction contracts" and "cleaning services." Letter of Findings 04-20110024 (November 2, 2011), 20120125-Ind. Reg.-045120023NRA, (the "LOF"), addressed the remaining issues, sustaining Retail Merchant in part and denying Retail Merchant in part.

Retail Merchant requested a rehearing on some of the issues that were denied in the LOF. Along with the request for rehearing, Retail Merchant submitted additional documentation in support of its request. The issues raised by Retail Merchant in its request for rehearing are titled as follows in its November 29, 2011 rehearing letter: "food and food ingredients," "cocktail mixes," "food thickeners," and "photo processing equipment."

The Department granted the rehearing and this Supplemental Letter of Findings ("SLOF") ensues. Retail Merchant requested that the Department's final determination be made based on the new documentation presented in lieu of an actual hearing. Additional facts will be provided as necessary.

**I. Sales and Use Tax – Food and Food Ingredients.**

**DISCUSSION**

The statement of the relevant law and discussion of that law is incorporated here by reference to the LOF. This SLOF will simply address the specific items under continued protest.

In its written request for rehearing, dated November 29, 2011, under the heading "Food and Food Ingredients," Retail Merchant states that:

The LOF acknowledges that (a) food items in the form of bars that contain "flour" are not candy and are exempt food; and (b) food items in a liquid form that contain milk or milk products, soy, rice or similar milk substitutes, or more than 50[percent] fruit or vegetable juice are not "soft drinks" and are exempt food. The LOF nevertheless treats various food items as taxable, even though they contain flour (in the case of bars) or milk or milk substitutes (in the case of liquids). Collectively marked and enclosed as **Exhibit B [ Emphasis in original]** is a spreadsheet listing the exempt food items erroneously treated as taxable in the LOF, along with copies of product labels, including nutritional facts labels showing the inclusion of flour or milk/milk substitutes.

(Emphasis added).

As a preliminary matter, Retail Merchant's statement above that "[t]he LOF nevertheless treats various food items as taxable, even though they contain flour (in the case of bars) or milk or milk substitutes (in the case of

liquids)" is incorrect. The LOF addressed the handful of items for which Retail Merchant had presented documentation detailing the ingredients contained in those items. Retail Merchant did not similarly document the almost 225 additional items it now continues to protest on rehearing. The LOF clearly states the basis of its denial on these items:

Retail Merchant did not provide either sample or relevant documentation for any of the other protested items under this section and therefore the items are taxable.

Retail Merchant cannot be sustained just on its bare assertion that a certain transaction is exempt from sales tax. Retail Merchant must demonstrate with documentary evidence the basis for its assertion of exemption. On rehearing, Retail Merchant presents the documentation it should have presented with its original protest and the Department is in a position to make a final determination on the substance of the issues.

Retail Merchant's new documentation consists of an Excel spreadsheet that lists approximately 225 items (including a statement of the basis for exemption of each item) along with a binder that identifies and provides the ingredient list of each and every one of the 225 remaining items.

The items on this list breakdown into several identifiable categories: "nutritional" bars, liquid drinks, powdered drink mixes, food and drink thickeners (also referred to as "thickeners"), protein powder packets, Bloody Mary mixes, and a lime mixer. This SLOF will address each of these categories. Retail Merchant is asked to refer to the LOF for the statement of the relevant law and analysis of that law, which is incorporated here by reference.

#### **"Nutritional" Bars**

The issue here is whether these "nutritional" bars are taxable "candy" or non-taxable "food or food ingredients." Again referencing the LOF, a candy is sweetened with natural or artificial sweeteners and is in the form of a "bar, piece, or drop" and does not contain flour or require refrigeration.

This SLOF will not list each "nutritional" bar by brand-name. Retail Merchant and the Department are directed to the spreadsheet provided by Retail Merchant to the Department (designated by Retail Merchant as "Exhibit B"). With two exceptions, Retail Merchant argues that the listed "nutritional" bars should be exempt because they contain flour as an ingredient. The two exceptions are Larabar Apple Pie bars and Larabar Cherry Pie bars ("Larabars"). Retail Merchant argues that the Larabars should be exempt because they do not contain additional natural or artificial sweeteners and therefore are not "candy."

Generally, items that contain natural or artificial sweeteners and are in the form of "bars, drops, or pieces," are taxable "candy," unless the item contains flour. If these items that contain natural or artificial sweeteners and are in the form of bars, also contain flour, then these items are not "candy" and are therefore considered food items not subject to tax.

Setting aside the Larabars, Retail Merchant has demonstrated that all the other "nutritional" bars listed in its Exhibit B contain some form of flour (such as wheat flour, rice flour, oat flour, etc.). Because these bars contain flour, they are not "candy" and are therefore considered "food or food ingredients." As "food or food ingredients" these bars are not subject to sales tax.

As for the referenced Larabars, even though they are in the form of "bars, drops, or pieces," the ingredients consist of different combinations of nuts and dried fruit without any additional natural or artificial sweeteners. In order to be a taxable "candy," an item must contain natural or artificial sweeteners and the Larabars do not contain additional listed natural or artificial sweeteners. Therefore, the Larabars are not "candy" and are therefore considered "food or food ingredients." As "food or food ingredients" the Larabars are not subject to sales tax.

Retail Merchant's protest of the taxability of all the "nutritional" bars listed on Exhibit B is sustained. A supplemental audit will remove these items from the sales tax assessment.

#### **Liquid Drinks**

The issue here is whether the protested liquid drinks are taxable "soft drinks" or non-taxable "food or food ingredients." Again referencing the LOF, a "soft drink" is a non-alcoholic drink that contains natural or artificial sweeteners. A "soft drink," however, cannot contain milk or milk products, soy, rice or similar milk substitutes, or more than 50 percent fruit or vegetable juice by volume.

This SLOF will not list each protested liquid drink by brand-name. Retail Merchant and the Department are directed to the spreadsheet provided by Retail Merchant to the Department (designated by Retail Merchant as "Exhibit B").

Retail Merchant must demonstrate that these liquid drinks are not taxable "soda drinks," by showing that the drinks that contain natural or artificial sweeteners, also contain milk or milk products, soy, rice or similar milk substitutes, or contain more than 50 percent fruit or vegetable juice by volume.

For all the liquid drinks on Exhibit B which Retail Merchant designates as exempt because the items contain milk and/or soy, Retail Merchant has provided documentation to so establish, and therefore the sale of these liquid drinks is not subject to sales tax. A supplemental audit will remove these items from the sales tax assessment.

#### **Powdered Drink Mixes**

A number of the items listed on Exhibit B are designated by Retail Merchant as exempt because they are a "powder mix."

As the LOF states, Sales Tax Information Bulletin 29 (July 2005 and August 2008) lists "powdered drink

mixes (including sweetened)" as a non-taxable food item.

Retail Merchant has documented the fact that these items are powdered drink mixes and therefore the sale of these powdered drink mixes is not subject to sales tax. A supplemental audit will remove these items from the sales tax assessment.

#### **Food and Drink Thickeners**

Retail Merchant originally protested the assessment of sales tax on its sales of food and drink thickeners and ingredients developed to prepare food for individuals who have difficulty swallowing. In its written request for rehearing, Retail Merchant claims that the LOF "holds that 'food thickeners' don't meet the statutory definition [of 'food and food ingredients']" and cautions that "legislative intent is not to be frustrated by applying absurd interpretations." The LOF's entire statement relating to this issue is as follows:

Retail Merchant protests the assessment of sales tax on its sales of food thickeners and ingredients developed to prepare food for individuals who have difficulty swallowing.

The definition of "food and food ingredients," IC § 6-2.5-1-20, states that these are items "that are sold for ingestion or chewing by humans and that are consumed for their taste or nutritional value." **Apart from a general description of this item, Retail Merchant has not provided any additional documentation to demonstrate what these "food thickeners" are or how they are used.**

Retail Merchant's protest of this item is denied **for lack of substantiation.**  
**(Emphasis added).**

Contrary to Retail Merchant's assertion that the Department is applying "absurd interpretations," nowhere does the LOF state that food thickeners do not meet the statutory definition of "food and food ingredients." Retail Merchant's characterization of the Department's position regarding these items in the LOF, therefore, does not correctly represent the Department's position.

Again, Retail Merchant cannot be sustained just on its bare assertion that a certain transaction is exempt from sales tax. Retail Merchant must demonstrate with documentary evidence the basis for its assertion of exemption. On rehearing, Retail Merchant presents the documentation it should have presented with its original protest and the Department is in a position to make a final determination on the substance of the issue.

The documentation provided by Retail Merchant on rehearing, shows that the items listed on Exhibit B with "Product UPC" designations ending with 21929, 17938, and 22510, are food grade corn starch used to thicken pureed food and liquids in order to assist people with swallowing disorders. Corn starch is a "food ingredient."

One of the protested items, with "Product UPC" designation ending with 41530, is a thickened apple juice, also designed for people with swallowing disorders. As a sweet drink, the question might arise whether this is a taxable "soft drink." However if a drink consists of 50-percent or more fruit or vegetable juice, it cannot be a taxable "soft drink." Based on the documentation Retail Merchant presented on rehearing, the only ingredients contained in this product are – according to the label in order of quantity – apple juice, corn starch, malic acid and ascorbic acid. Retail Merchant has provided sufficient documentation to allow the Department to conclude that this thickened apple juice is a non-taxable "food or food ingredient."

Retail Merchant has, on rehearing, documented the fact that these thickeners and the thickened apple juice are "food and food ingredients" and therefore not subject to sales tax. A supplemental audit will remove these items from the sales tax assessment.

#### **Bloody Mary and Lime Juice Cocktail Mixers**

Retail Merchant continues to protest "cocktail mixers" – specifically Bloody Mary mixers and a lime mixer. The LOF denied Retail Merchant's protest of these items pursuant to Sales Tax Information Bulletin 29 which states that dry or liquid "cocktail mixers" are taxable.

Retail Merchant continues to protest that the "cocktail mixers" are more than 50 percent vegetable or fruit juice (therefore not soda drinks), that they are sold for human consumption, and do not contain alcohol. Retail Merchant argues that the referenced information bulletin is not correct and does not reflect the law.

Retail Merchant presents Streamlined Sales Tax Project ("SSTP") Interpretive Opinion 2009-2 (September 30, 2009), an interpretive opinion made to the governing board of the Streamlined Sales and Use Tax Agreement by its Compliance Review and Interpretive Committee. The issue addressed in that opinion was whether a fruit flavored cocktail mix was a taxable soft drink. The product referenced contained no fruit or vegetable juice. In rendering its decision, the Committee emphasized that a "soft drink" does not include beverages that include greater than fifty percent vegetable or fruit juice by volume. The Committee found that this particular cocktail mix was a taxable soft drink because it was sweetened drink and contained no fruit or vegetable juice, much less 50 percent by volume. It is not clear what additional information Retail Merchant wishes to convey by referring to this opinion, other than to reiterate the statement of the law with which the Department agrees.

Retail Merchant points to the product label of the Bloody Mary mixes which state that the mixes "contain 95[percent] juice." However the product label also lists the following ingredients in the order of quantity: water, tomato juice concentrate, high fructose corn syrup, and vinegar. The product label also lists other ingredients, none of which are a fruit or vegetable juice. A review of the documentation presented by Retail Merchant presents seemingly conflicting information. On the one hand the product label states that the product contains 95-percent juice. On the other hand, water appears to be present in greater volume than the tomato concentrate, so it is not

clear what the 95-percent juice designation means.

The lime mixer label states that the product "contains 100[percent] juice." The product label also lists the following ingredients in order of quantity: water, high fructose corn syrup, concentrated lime juice, and couple of other ingredients. On the one hand, the product label states that the product contains 100 percent juice. On the other hand, water and high fructose corn syrup appear to be present in greater volume than the lime juice concentrate, so it is not clear what the 100 percent juice designation means.

Presumably the product labeling comports with FDA requirements to ascribe some meaning to these juice percentage designations. However, in the absence of a further explanation by Retail Merchant, the Department cannot properly evaluate the vegetable juice content of the Bloody Mary mixes or the lime juice mixer in light of the requirement that 50 percent vegetable and/or fruit juice by volume needs to be present in these sweetened liquids for them to not be subject to sales tax.

Given the ambiguity discussed above – and even if, for the sake of argument, the Department's Sales Tax Information Bulletin 29 is incorrect (which this SLOF does not concede) – and given that exemption is to be interpreted narrowly and in favor of taxation, the Bloody Mary mixers and the lime juice mixer remain taxable.

**Protein Powder**

Exhibit B contains one listed item that consists of protein powder packets. Retail Merchant designates this item as exempt because it is a "powdered protein drink." This item is actually a protein powder additive to food or drinks.

Again referring to the statutory definition of "food and food ingredients" referenced in the LOF, this item is a substance sold for ingestion by humans and consumed for its nutritional value. Based on the information provided, this item does not fall into any of the grocery item categories that would render it taxable, such as "candy."

Therefore, as a "food ingredient," the sale of this item is not subject to sales tax. A supplemental audit will remove these items from the sales tax assessment.

**FINDING**

This SLOF sustains Retail Merchant on certain of the items denied in the LOF under this Issue heading. Retail Merchant's protest on rehearing is therefore sustained in part and denied in part. Specifically all of the items claimed for exemption from sales tax on Exhibit B are sustained, except for the cocktail mixers.

**II. Sales and Use Tax – Manufacturing Exemptions – Credit for Tax Paid.**

**DISCUSSION**

Retail Merchant originally protested that the Department did not give Retail Merchant credit for sales and use tax it paid on purchases from certain vendors of items Retail Merchant described as photo processing equipment, including materials consumed in the production process, items that became component parts of the produced product, and parts for the processing equipment under IC § 6-2.5-5-3, IC § 6-2.5-5-4, IC § 6-2.5-5-5.1; and IC § 6-2.5-5-6.

During the initial hearing process Retail Merchant requested that a supplemental audit review the voluminous vendor documentation relating to this issue. However, the LOF stated that "before a supplemental audit can do so, there needs to be a finding addressing the legal contentions relating to the manufacturing exemption(s) being claimed by Retail Merchant."

In response, Retail Merchant states, in its letter requesting rehearing, that:

[Retail Merchant] manufactures photographs using its photo processing equipment. The applicability of the manufacturing exemption cannot really be in question. In fact, the auditor recognized that the manufacturing exemptions applied in addressing other photo processing invoices; but the auditor simply failed to take into account certain invoices and provided no explanation for doing so. [...] [Retail Merchant] can't address the auditor's specific contentions because the auditor made no such contentions.

Retail Merchant lists on Exhibit E the items for which it is claiming credit of sales tax paid. This list contains over 1800 line items that identify vendors, invoice numbers and dates, etc., but no description of the items. For example:

Vendor Number	Check Number	Check Date	Vendor Name	Invoice Number	Invoice Date	Invoice Amount	Additional Amount	Payment Amount	Store Number	Account Number	Entered Date	Voucher Number	Remit Source	Remit Number
15793	5331917	20060505	[EKC]	0109190578	20060405	3,365.50	0.00	3,365.50	06567	2002	20060409	88681734		15793

Setting aside the question of whether Retail Merchant made (or even need have made) the case for exemption, a review of the first third of items on Exhibit E shows that the Department's audit has already given credit for those items (see Audit Summary starting on page 88). Retail Merchant has all along asked for a supplemental audit of these items. However, an audit was already conducted. For a supplemental audit to be appropriate at this level of protest, Retail Merchant is expected to show with specificity what items it believes were not granted credit and why credit should be given. The burden is on Retail Merchant to make that case. Retail Merchant has done neither.

**FINDING**

Retail Merchant's protest is respectfully denied.

**SUMMARY**

On Issue I, Retail Merchant's protest is sustained in part and denied in part. On Issue II, Retail Merchant is denied.

*Posted: 08/29/2012 by Legislative Services Agency*  
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