

**Letters of Findings: 04-20130367**  
**Sales and Use Tax**  
**For the Years 2010 and 2011**

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**ISSUES**

**I. Sales and Use Tax – Imposition.**

**Authority:** IC § 6-2.5-1-1 et seq.; IC § 6-2.5-1-2; IC § 6-2.5-1-27; IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-4-1; IC § 6-2.5-5-3; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; IC § 6-8.1-5-4; Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); Mumma Bros. Drilling Co. v. Department of Revenue, 411 N.E.2d 676 (Ind. Ct. App. 1980); Indiana Dep't. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983); General Motors Corp. v. Indiana Dep't. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax. Ct. 1993); Rhoads v. Indiana Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); 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. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-11](#); [45 IAC 2.2-5-12](#).

Taxpayer protests the assessments of sales tax on sales of cubed ice and drinking water as well as use tax on its various purchases of tangible personal property.

**II. Tax Administration – Interest.**

**Authority:** IC § 6-8.1-10-1.

Taxpayer protests the imposition of statutory interest.

**III. Tax Administration – Negligence Penalty.**

**Authority:** IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the imposition of a ten percent negligence penalty.

**STATEMENT OF FACTS**

Taxpayer is an Indiana company, which sells cubed ice and drinking water from automated vending machines ("Vending Machines"). The Vending Machines, which use the water purchased from the local water utility, manufacture and dispense cubed ice and drinking water for sale. Customers can purchase cubed ice or drinking water by inserting cash into money acceptors located at the front of the Vending Machines.

In late 2012, the Indiana Department of Revenue ("Department") audited Taxpayer's business records for the tax years 2010 and 2011. Pursuant to the audit, the Department determined that Taxpayer failed to remit the proper amount of sales tax on its sales of the cubed ice and drinking water. The Department's audit also determined that Taxpayer purchased certain tangible personal property to be used in the course of its business without paying sales tax or self-assessing use tax. As a result, the Department assessed additional sales tax, use tax, penalty, and interest.

Taxpayer protested the assessments. A phone hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

**I. Sales and Use Tax – Imposition.**

**DISCUSSION**

The Department's audit, after examining Taxpayer's records, determined that Taxpayer did not have a reliable method of tracking its sales of ice and water sold from the Vending Machines. The Department's audit thus imposed additional sales tax based on the best information available at the time of the audit. The Department's audit also found that Taxpayer purchased certain tangible personal property to be used for its business operation but it did not pay sales tax or self-assess use tax. The Department's audit thus assessed use tax on the purchases.

Taxpayer disagrees, claiming that the audit's assessments were overstated and that it was not responsible for the assessments.

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 Dep't. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012).

**A. Sales Tax on Sales of Cubed Ice and Drinking Water.**

The Department's audit, after examining Taxpayer's records, determined that Taxpayer did not have a reliable method of tracking its sales of cubed ice and drinking water sold from the Vending Machines. As a result, the Department's audit utilized Taxpayer's water purchase invoices (i.e., monthly water bills) to compute the total gallons of water purchased in producing the cubed ice and drinking water for sale and allowed 500 gallons of

water per month for shrinkage ("Shrinkage"). The audit considered that the Shrinkage accounted for various causes, including "melting of ice that is stored in the unit after production due to temperature fluctuations, leakage of water from the lines, or external faucets left on by offenders, malfunctioning of the machines and boil water advisories from the utility company."

Taxpayer objects to the method proposed by the Department's audit, claiming that the method cannot determine the reliable and verifiable amount of sales for the 2010 and 2011 tax years.

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. "Tangible personal property," as defined in IC § 6-2.5-1-27, "means personal property that: (1) can be seen, weighed, measured, felt, or touched; or (2) is in any other manner perceptible to the senses," including "electricity, water, gas, steam, and prewritten computer software."

IC § 6-2.5-2-1 states:

- (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 § 6-2.5-4-1, in pertinent part, states:

- (a) A person is a retail merchant making a retail transaction when he engages in selling at retail.
- (b) A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he:
  - (1) acquires tangible personal property for the purpose of resale; and
  - (2) transfers that property to another person for consideration.
- (c) For purposes of determining what constitutes selling at retail, it does not matter whether:
  - (1) the property is transferred in the same form as when it was acquired;
  - (2) the property is transferred alone or in conjunction with other property or services; or
  - (3) the property is transferred conditionally or otherwise.

In this instance, Taxpayer disagrees with the method used in the Department's audit. Specifically, Taxpayer argues that the Department's audit cannot use its 2010 and 2011 purchase invoices and then arbitrarily allow the Shrinkage to determine the amount of Taxpayer's 2010 and 2011 sales tax on its sales of cubed ice and drinking water. Taxpayer claims that the audit's estimated Shrinkage did not fully consider various reasons which caused the Shrinkage.

Taxpayer further asserts that the audit overestimated Taxpayer's sales for the 2010 and 2011 tax years. Taxpayer states that, in September 2012, it installed monitoring systems in its Vending Machines. The monitoring systems collect "real time" data on the sales of its cubed ice and drinking water. After compiling the data recorded by the monitoring systems from September 2012 through August 2013, Taxpayer presented the information in an Excel summary to support its protest. Taxpayer also submits various photos to demonstrate several circumstances in which the water it purchased was not used to produce saleable cubed ice or drinking water.

Upon reviewing Taxpayer's supporting documentation, however, its reliance is misplaced. First, the Department audited Taxpayer's records for the 2010 and 2011 tax years. Taxpayer, to the contrary, refers to its Excel summary, which contains information from September 2012 through August 2013 to support its contention that the audit assessments were overstated. Thus, Taxpayer's post-audit information is outside the audit and is beyond the scope of the protest.

Additionally, IC § 6-8.1-5-4(a) provides:

Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks.

IC § 6-8.1-5-1(b), in relevant part, further states "[i]f the department reasonably believes that a person has not reported the proper amount of tax due, **the department shall** make a proposed assessment of the amount of the unpaid tax **on the basis of the best information available to the department**. The amount of the assessment is considered a tax payment not made by the due date and is subject to [IC 6-8.1-10](#) concerning the imposition of penalties and interest." (**Emphasis added**).

In this instance, both Taxpayer and the Department agree that not all of the water Taxpayer purchased was used to produce cubed ice and drinking water for sale. Also, both Taxpayer and the Department agree that Shrinkage occurred for various reasons during the tax years at issue. However, Taxpayer did not maintain adequate records for the tax years at issue so that the Department can determine the proper amount of tax by reviewing Taxpayer's records. Pursuant to the above referenced statutes, if the Department reasonably believes that Taxpayer has not reported the proper amount of tax due, the Department is only required to make a proposed assessment on the basis of the best information available to the Department. Thus, given the totality of the circumstances, in the absence of other supporting documentation, the Department is not able to agree that Taxpayer met its burden of proof to demonstrate that the proposed assessment is wrong.

**B. Use Tax on Purchases of Tangible Personal Property.**

The Department's audit determined that Taxpayer failed to pay sales tax or remit use tax on various tangible personal property it purchased and used in the course of its business, which include a "Sediment Filter," a "Hockey puck lock," a "Sanitation kit," a "Liquid hand sanitizer," a hose, a sanitizing spray bottle, gloves, a glove dispenser, a low ambient valve and heat strip, and a hot water sink ("Items at Issue"). Taxpayer, to the contrary, claims that it was not responsible for the tax because the Items at Issue are used to produce ice and, therefore, were exempt from the sales/use tax.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). Indiana also imposes a complementary excise tax called "the use tax" 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." IC § 6-2.5-3-2(a). "Use" means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The use tax is functionally equivalent to the sales tax. See *Rhoades v. Indiana Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. *Id.*; *USAir, Inc. v. Indiana Dep't of State Revenue*, 623 N.E.2d 466, 468–69 (Ind. Tax. Ct. 1993). The use tax ensures that, after such goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. *Id.* A taxable retail transaction occurs when (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), (c); IC § 6-2.5-3-2(a).

Generally, 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 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, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Id.* at 101.

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. (Emphasis added).**

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. **(Emphasis added).**

Thus, the Legislature granted Indiana manufacturers a sales tax exemption for certain purchases, which are for "direct use in direct production, manufacture . . . of other tangible personal property." In enacting the exemption, the Legislature clearly did not intend to create a global exemption for any and all equipment which a manufacturer purchases for use within its manufacturing facility. "Fairly read, the exemption was meant to apply to capital equipment that meets the 'double direct' test." *Mumma Bros. Drilling Co. v. Department of Revenue*, 411 N.E.2d 676, 678 (Ind. Ct. App. 1980). The capital equipment "in order to be exempt, (1) must be directly used by the purchaser and (2) be used in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of tangible personal property." *Indiana Dep't. of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520, 525 (Ind. 1983). "The test for directness requires the equipment to have an 'immediate link with the product being produced.'" *Id.* Accordingly, the sales tax exemption is applicable to that equipment which meets the "double direct" test and is "essential and integral" to the manufacture of taxpayer's tangible personal property. *General Motors Corp. v. Indiana Dep't. of State Revenue*, 578 N.E.2d 399, 401 (Ind. Tax Ct. 1991). The application of Indiana's double-direct manufacturing exemptions often varies based on a determination of when a taxpayer's manufacturing process is considered to have begun and ended.

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 direct 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), example 1.

[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.

The exemption for direct consumption in production is further explained at [45 IAC 2.2-5-12](#), in part, as follows:

(a) The state gross retail tax shall not apply to sales of any tangible personal property consumed in direct production by the purchaser in the business of producing tangible personal property by manufacturing, processing, refining, or mining.

(b) The exemption provided by this regulation [[45 IAC 2.2](#)] applies only to tangible personal property to be directly consumed in direct production by manufacturing, processing, refining, or mining. It does not apply to machinery, tools, and equipment used in direct production or to materials incorporated into the tangible personal property produced.

(c) The state gross retail tax does not apply to purchases of materials to be directly consumed in the production process or in mining, provided that such materials are directly used in the production process; i.e., they have an immediate effect on the article being produced. 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.

[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. (Emphasis added).**

[45 IAC 2.2-5-8](#)(h) provides:

(1) **Machinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax.**

(2) Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax. **(Emphasis added).**

Additionally, [45 IAC 2.2-5-8](#)(j) provides:

**Machinery, tools, and equipment used in managerial sales, research, and development, or other non-operational activities, are not directly used in manufacturing and, therefore, are subject to tax.**

This category includes, but is not limited to, tangible personal property used in any of the following activities: management and administration; selling and marketing; exhibition of manufactured or processed products;

safety or fire prevention equipment which does not have an immediate effect on the product; space heating; ventilation and cooling for general temperature control; illumination; heating equipment for general temperature control; and shipping and loading. (**Emphasis added**).

In this instance, Taxpayer claims that it was not responsible for the tax because its purchases of the Items at Issue were used in an exempt manner. Taxpayer explains the needs of purchasing and using the Items at Issue. However, upon review, Taxpayer's documentation fails to demonstrate that Taxpayer directly used the Items at Issue in its direct production. As mentioned earlier, "[t]he 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.'" Given the totality of the circumstances, in the absence of other supporting documentation, the Department is not able to agree that Taxpayer met its burden to demonstrate that the Department's assessment is not correct.

#### FINDING

Taxpayer's protest of imposition of sales tax (Part A.) and use tax (Part B.) is respectfully denied.

### II. Tax Administration – Interest.

#### DISCUSSION

The Department assessed interest on the tax liabilities. Taxpayer protested the imposition of interest.

IC § 6-8.1-10-1(a) provides, as follows:

If a person fails to file a return for any of the listed taxes, fails to pay the full amount of tax shown on the person's return by the due date for the return or the payment, or incurs a deficiency upon a determination by the department, the person is subject to interest on the nonpayment.

Pursuant to IC § 6-8.1-10-1(e), the Department does not have the authority to waive the interest.

#### FINDING

Taxpayer's protest regarding the imposition of interest is respectfully denied.

### III. Tax Administration – Negligence Penalty.

#### DISCUSSION

Taxpayer also protests the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1(a), the Department may assess a ten (10) percent negligence penalty if the taxpayer:

- (1) fails to file a return for any of the listed taxes;
- (2) 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;
- (3) incurs, upon examination by the department, a deficiency that is due to negligence;
- (4) fails to timely remit any tax held in trust for the state; or
- (5) is required to make a payment by electronic funds transfer (as defined in [IC 4-8.1-2-7](#)), overnight courier, or personal delivery and the payment is not received by the department by the due date in funds acceptable to the department.

[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 has provided sufficient documentation establishing that his failure to pay tax or 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 sustained.

**SUMMARY**

For the reasons discussed above, Taxpayer's protest of the imposition of the negligence penalty is sustained. However, the remainder of Taxpayer's protest is respectfully denied.

*Posted: 02/26/2014 by Legislative Services Agency*

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