

Letter of Findings: 04-20120664
Use Tax
For the Tax Years 2009, 2010, and 2011

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is suspended by the publication of another document in the Indiana Register.

ISSUES

I. Use Tax – Industrial Production Exemptions.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-1-24; IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-3-3; IC § 6-2.5-3-4; IC § 6-2.5-4-1; IC § 6-2.5-5 et seq.; IC § 6-2.5-5-3; IC § 6-2.5-5-6; IC § 6-8.1-5-1; Lafayette Square Amoco, Inc. v. Indiana Dep't of 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); Rhoades v. Ind. Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); [45 IAC 2.2-4-2](#); Indiana Dep't of Revenue v. Cave Stone Inc., 457 N.E.2d 520 (Ind. 1983); 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); Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); Department of Revenue v. U. S. Steel Corp., 425 N.E.2d 659 (Ind. Ct. App. 1981); Indiana Dep't of State Revenue v. Harrison Steel Casting, 402 N.E.2d 1276 (Ind. Ct. App., 1980); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-14](#).

Taxpayer protests the assessment of use tax on certain items because it believes they are subject to the industrial production exemptions.

II. Use Tax – Packaging Exemption.

Authority: IC § 6-2.5-5-9; [45 IAC 2.2-5-16](#).

Taxpayer protests the assessment of use tax on certain items it considers subject to the non-returnable packaging exemption.

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 formulator and manufacturer of thermostat molding compounds. All sales are directly to manufacturers. Taxpayer is a disregarded entity for income tax purposes and is included in its parent's 1120S return for federal purposes and the IT-20S for Indiana income tax purposes. Taxpayer is registered as a retail merchant in Indiana.

The Indiana Department of Revenue (the "Department") audited Taxpayer's business and tax records for sales and use tax compliance for the tax years 2009, 2010, and 2011. A review of transactions made during a test period (July through September 2011) revealed that all sales were exempt. However, as a result of the audit, the Department assessed Taxpayer additional use tax, penalty, and interest for those periods. Taxpayer protested a portion of the assessments. A hearing was held on Taxpayer's protest, and this Letter of Findings ensues. Additional facts will be presented as needed.

I. Use Tax – Industrial Production Exemptions.

DISCUSSION

Taxpayer did not remit use tax to the Department during the audit period even though Taxpayer had been previously audited by the Department. Taxpayer claims that all its purchases are subject to the industrial production exemptions.

Because of the large volume of Taxpayer records, a projection method was used to determine Taxpayer's additional taxable purchases to which Taxpayer agreed. Certain vendor purchases from 2011 were selected to be reviewed as representative of the audit period. An error rate was determined based upon purchases made by Taxpayer for items used in its business and for which no sales tax was paid at the point of purchase or where Taxpayer could not provide evidence that it paid sales tax. The errors noted were totaled by account and represent the numerator of the account error percentage. The denominator base consists of the account balances for the accounts where errors were noted during the test period. For 2009 and 2010, the Department's audit multiplied the error percentage by the account balance totals for the same accounts where errors were noted for 2011 during the test period. However, Taxpayer did not provide the account balances for 2009 and 2010, therefore, the Department's audit adjusted the 2011 account balances using the annual Producer Price Index (which is published by the Bureau of Labor Statistics using data from manufacturing industries). Items purchased by Taxpayer for which Taxpayer could not provide evidence of sales tax paid at the point of purchase include gloves, pallets, building maintenance items, advertising, equipment repair, small tools, office supplies, computer supplies, printing items, safety items, subscriptions, and other items.

All of Taxpayer's capital asset purchase invoices and depreciation schedules for assets purchased during the

audit period were reviewed. Taxpayer purchased software, warehouse racking, maintenance materials, a forklift, and other items for use in its business. Taxpayer was unable to provide evidence that sales tax had been paid on these capital assets at the point of purchase.

As a threshold issue, 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. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of 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).

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). In effect and practice, the use tax is generally functionally equivalent to the sales tax. See *Rhoades v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

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. IC § 6-2.5-5 et seq.

"In general, 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\(a\)](#).

There is an exemption that applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. Id. Machinery, tools, and equipment are directly used in the production process if they have an immediate effect on the article being produced. Id. A machine, tool, or 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. [45 IAC 2.2-5-8\(c\)](#); *Indiana Dep't of Revenue v. Cave Stone Inc.*, 457 N.E.2d 520 (Ind. 1983). 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\(c\)\(1\)](#).

Again, the general rule is that 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\(a\)](#). The exemption only applies to machinery, tools, and equipment directly used by the purchaser in direct production.

A taxpayer claiming exemption has the burden of showing the terms of the exemption statute are met. *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991) aff'd 599 N.E.2d 588 (Ind. 1992) (Internal citations omitted). A statute which provides a tax exemption is strictly construed against the taxpayer. *Indiana Dept'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 (internal citations omitted). **(Emphasis added)**. 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." *General Motors Corp.* at 404.

In order to determine whether an item is directly used in Taxpayer's direct production process, it is necessary to identify Taxpayer's production process in order to determine what falls within it (and is therefore exempt), or whether a particular process falls in pre-production or post-production (and is therefore not exempt under the manufacturing exemptions).

[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.

Further, as [45 IAC 2.2-5-8\(g\)](#) explains, "[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." (Internal quotation marks omitted).

Taxpayer operates a production facility which undoubtedly contains equipment and processes which are entitled to the cited exemptions. However, there are also undoubtedly areas which are outside the "integrated production process" which would preclude Taxpayer from claiming the relief it seeks. Under IC § 6-8.1-5-1(c), Taxpayer is required to prove the original assessment was wrong.

During the Department's audit, the auditor requested additional information from Taxpayer to substantiate its claims for the industrial production exemptions. Taxpayer did not provide any documentation during the audit. Subsequent to the hearing, Taxpayer provided some documentation which will be addressed as each of the protested items is discussed below.

(1) Gloves

Taxpayer protests the assessment of use tax on its use of certain gloves. IC § 6-2.5-5-3 provides an exemption for equipment directly used in the direct production of tangible personal property. In support of its protest, Taxpayer states:

Gloves are required by our employees throughout the entire production process. In particular, because our product is made with Fiberglass, which can result in a skin irritation along with to prevent any contamination. Along with this statement, Taxpayer presented several photographs of its employees wearing gloves during its production process.

[45 IAC 2.2-5-8\(c\)](#) states:

The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. 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.

--EXAMPLES--

...

(2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product, is not determinative.

...

(F) Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.

(Emphasis added).

In *Department of Revenue v. U. S. Steel Corp.*, 425 N.E.2d 659 (Ind. Ct. App. 1981), the appellate court affirmed the trial court's findings, in favor of the taxpayer, U.S. Steel Corp., that it was entitled to the manufacturing exemption concerning its purchases of personal protective equipment, including, but not limited to, prescription safety eyeglasses, protective mittens, hardhats, goggles, masks, hoods, jackets and aprons. The U.S. Steel court refined the application of the "double direct standard" illustrated in *Indiana Dep't of State Revenue v. Harrison Steel Casting*, 402 N.E.2d 1276 (Ind. Ct. App., 1980) and focused on "whether the safety equipment is an integral part of manufacturing and operates directly on the product during production." *US Steel*, 425 N.E.2d at 664.

Acknowledging that the "U.S. Steel's safety equipment was one of the tools used by workers to accomplish the job," The U.S. Steel court concluded that:

Since steel can be made only because shielded workers deal directly with the raw materials of the product, the shields not only protect the worker but are a part of manufacturing which operates directly on the product during production.

U.S. Steel, 425 N.E.2d at 664.

In *U.S. Steel*, but for the shields, the workers would not have been able to directly handle the materials used in the production process.

Taxpayer met its burden of demonstrating that the gloves were directly used by its employees in the direct manufacturing process to protect themselves from injury and to prevent contamination of its product.

Therefore, Taxpayer is sustained on its protest of the assessment of use tax on the gloves.

(2) Mitsubishi Forklift

Taxpayer protests the assessment of use tax on a Mitsubishi forklift citing to [45 IAC 2.2-5-8\(f\)](#), which states in relevant part:

(3) Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.

Taxpayer states that the "[f]orklift [is] needed to transport WIP [work in process] to a temporary storage area as part of the production process along with materials within the production process." Obviously, it is not enough for Taxpayer to mirror the requirements of the regulation. Taxpayer also provided photographs that purport to show the forklift being used in the production process. Two of four photographs presented by Taxpayer show the forklift being directly used in what appears to be Taxpayer's direct production process, thus rendering the use exempt. However, the two other photographs do not show the direct use of the forklift in the direct production process. In these photographs the forklift appears to be (1) moving items to a loading dock which would be a post-production process, and (2) parked in the middle of a non-production area of the plant which does not provide any definitive production information about the use of the forklift.

Taxpayer is reminded that it is not enough for the forklift to be generally used at its production facility in order to meet the standard for industrial production exemption. In order for the use of the forklift to be exempt, it must be used directly in the direct production process. It appears that the subject forklift may indeed be partially directly used in Taxpayer's direct production process. However, given that there is also apparently non-exempt use of the forklift, and Taxpayer has still not provided sufficient documentation to quantify the exempt use of the forklift, Taxpayer has not met its burden to show the exempt use of the forklift.

Therefore, absent the required documentation, Taxpayer is denied on its protest of the assessment of use tax on the Mitsubishi forklift.

(3) Floor Coating Materials

Taxpayer protests the assessment of use tax on materials used to coat the floor of one of the rooms at its plant. Taxpayer states:

The Building that we operated in is old and thru time certain aspects of the facility have become worn and in need of an update. As Referenced White Room, this area was in need of attention and in particular the floor. Due to the nature of the floor being heavily worn and in disrepair materials were used to level the surface and fill in the areas w[h]ere the floor was in disrepair.

The completion of this project aided in the production process for the activities that are done in this area along with the safety aspect.

The flooring in Taxpayer's production facility, while obviously part of the plant itself, is not directly used in Taxpayer's direct production process. The floor does not have an immediate effect on the production process. As [45 IAC 2.2-5-8\(g\)](#) explains, "[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." (Internal quotation marks omitted).

Taxpayer's protest of the assessment of use tax on materials used to repair its flooring is denied.

(4) Warehouse Racking

Taxpayer protests the assessment of use tax on warehouse racks that it uses at its facility. Taxpayer states that the "[r]acking is used within our facility for Temporary Storage of WIP [work-in-process] items in a controlled temperature environment as part of the manufacturing process." Taxpayer cites to [45 IAC 2.2-5-8\(e\)\(3\)](#). [45 IAC 2.2-5-8\(e\)](#) states:

(e) Storage equipment. Tangible personal property used in or for the purpose of storing raw materials or finished goods is subject to tax except for temporary storage equipment necessary for moving materials being manufactured from one (1) machine to another or from one (1) production step to another.

(1) Temporary storage. Tangible personal property used in or for the purpose of storing work-in-process or semi-finished goods is not subject to tax if the work-in-process or semi-finished goods are ultimately completely produced for resale and in fact resold.

(2) Storage containers for finished goods after completion of the production process are subject to tax.

(3) Storage facilities or containers for materials or items currently undergoing production during the production process are deemed temporary storage facilities and containers and are not subject to tax.

In support of this contention, Taxpayer presented a photograph of racking in a storage area with cardboard boxes and what look like plastic bins on the racks. There is no indication that what is stored in these containers is work-in-process and not Taxpayer's finished product. As per the above referenced regulation, storage containers for finished goods after completion of the production process are subject to tax. [45 IAC-2.2-5-8\(e\)\(2\)](#). Without further information showing that the racking is used to store work-in-process either exclusively or part of the time, Taxpayer has not met its burden to show the racks are fully or partially exempt.

Therefore, based on the above and without more information, Taxpayer's protest of the assessment of use tax on these warehouse racks is denied.

(5) Lubs Air Compressor Replacement Parts

Taxpayer protests the assessment of use tax on replacement parts for a Lubs air compressor. Taxpayer states these are "air compressor replacement parts for the compressors that are used in direct production of our equipment." Taxpayer presented photographs of the air compressor. However, Taxpayer did not provide any information, photographic or otherwise, that shows how the air compressor is connected to its production process. For the air compressor replacement parts to be exempt, the air compressor itself would have to be directly used in direct production.

Therefore, based on the above and without more information, Taxpayer's protest of the assessment of use tax on replacement parts for a Lubs air compressor is denied.

(6) Oil Used for the Compressors

Taxpayer protests the assessment of use tax on oil used in the compressors. Taxpayer states that this is "[o]il that is used in our compressors which are used in direct production of our equipment." Again, Taxpayer did not provide any information that shows how the air compressor(s) is connected to Taxpayer's production process. For the oil to be exempt, the air compressor(s) itself would have to be directly used in the Taxpayer's direct production process.

Therefore, based on the above and without more information, Taxpayer's protest of the assessment of use tax on the oil is denied.

(7) Cooling Tower

Taxpayer protests the assessment of use tax on a cooling tower. Taxpayer states:

A cooling tower is used to ensure that the product's temperature within the equipment does not go outside of specifications[.] In the event that the product is outside the desired temperature range it can [a]ffect the products performance.

Taxpayer presented photographs of a cooling tower connected to Taxpayer's plant. However, Taxpayer does not provide specific explanation of how the cooling tower is actually connected to Taxpayer's production process. It is entirely likely that the cooling tower is at least partially exempt, but other than the generalized statement above, Taxpayer has not presented more detailed explanation of how the cooling tower is used.

Therefore, based on the above and without further information, Taxpayer's protest of the assessment of use tax on the cooling tower is denied.

(8) Supplies from Motion Industries

Taxpayer protests the assessment of use tax on supplies it purchased from Motion Industries. Taxpayer states that "[t]his vendor supplies us with replacement equipment parts for use in our direct production." The Department's audit summary describes these items as "building maintenance" supplies which would suggest they are not directly used in direct production. Again, Taxpayer does not provide specific explanation of what equipment the replacement parts are used for, and how that equipment is directly used in direct production.

Therefore, based on the above and without further information, Taxpayer's protest of the assessment of use tax on supplies from Motion Industries is denied.

(9) Items from Versatile Mold and Design

Taxpayer protests the assessment of use tax on items from Versatile Mold and Design. Taxpayer states: Molds are purchased/made to [e]nsure the quality control of [f] our products. More specifically as part of QC our product is extruded through our equipment to ensure that our product conforms to the customer specifications.

Taxpayer fails to cite to any statutes or regulations in protesting the assessment of tax on this item, but presumably Taxpayer is referring to [45 IAC 2.2-5-8\(i\)](#), which states:

Testing and inspection. Machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt.

–EXAMPLE–

Selected parts are removed from production according to a schedule dictated by statistical sampling methods. Quality control equipment is used to test the parts in a room in the plant separate from the production line. Because of the functional interrelationship between the testing equipment and the machinery on the production line and because of the product flow, the testing equipment is an integral part of the integrated production process and is exempt.

Apart from its statement above, Taxpayer has not provided a more specific description of the use of these items along with, for example, documentation of industry standards or customer specifications that illustrate the necessity for their use during production.

Therefore, based on the above and without further information, Taxpayer's protest of the assessment of use tax on its use of these items purchased from Versatile Mold and Design is denied.

(10) Labels

Taxpayer protests the assessment of use tax on certain labels. Taxpayer states that the labels are an "integral component of the finished goods." Taxpayer provides photographs that depict the use of the contested labels. The labels appear to be affixed to the exterior of large cardboard boxes and other large containers. Taxpayer states that these containers hold "finished goods," but there is no visual depiction of the contents. Taxpayer cites to [45 IAC 2.2-5-14\(d\)](#) in support of its protest of the assessment of use tax on the labels.

IC § 6-2.5-5-6 states in relevant part:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for incorporation as a material part of other tangible personal property which the purchaser manufactures, assembles, refines, or processes for sale in his business. . . .

[45 IAC 2.2-5-14](#) elaborates:

- (a) The state gross retail tax shall not apply to sales of any tangible personal property which is to be incorporated by the purchaser as a material or an integral part into tangible personal property produced for sale by such purchaser in the business of manufacturing, assembling, refining or processing.
- (b) The exemption provided by this regulation [[45 IAC 2.2](#)] applies only to tangible personal property to be incorporated as a material or an integral part into tangible personal property produced for sale by a purchaser engaged in the business of manufacturing, assembling, refining or processing. This regulation [[45 IAC 2.2](#)] does not apply to persons engaged in producing tangible personal property for their own use.
- (c) This regulation [[45 IAC 2.2](#)] does not exempt from tax tangible personal property to be used in production, such as supplies, parts, fuel, machinery, etc., refer to Regs. 6-2.5-5-5(010) and 6-2.5-5-5(020) (dealing with material consumed in direct production) for the application of those regulations to taxpayers engaged in the production of tangible personal property.
- (d) The purchase of tangible personal property which is to be incorporated by the purchaser as a material or an integral part is exempt from tax. "Incorporated as a material or an integral part into tangible personal property for sale by such purchaser" means:

- (1) That the material must be physically incorporated into and become a component of the finished product;

- (2) The material must constitute a material or an integral part of the finished product; and
- (3) The tangible personal property must be produced for sale by the purchaser.
- (e) Application of general rule.
 - (1) Incorporation into the finished product. The material must be physically incorporated into and become a component part of the finished product.
 - (2) Integral or material part. The material must constitute a material or integral part of the finished product.
 - (3) The finished product must be produced for sale by the purchaser.

These labels, according to the photographs Taxpayer presented, appear to contain descriptions of the content of the containers, inventory tracking bar codes and numbers, and identification of the taxpayer. There can be little dispute that Taxpayer's labels are an essential component within taxpayer's marketing and distribution process. Notwithstanding, the use by Taxpayer of these labels is not entitled to the industrial production exemption afforded under IC § 6-2.5-5-6 because the labels do not become a "material part" of Taxpayer's products. The labels do not "constitute a material or integral part of the finished product," because the labels are not essential to Taxpayer's finished product. [45 IAC 2.2-5-14](#)(d)(2). The labels are not themselves an actual physical part of the "finished good." The labels are merely the ancillary means by which Taxpayer's finished product finds its way to the ultimate consumer.

Taxpayer has not shown that the labels it uses qualify for the industrial production incorporation exemption set out in IC § 6-2.5-5-6 and [45 IAC 2.2-5-14](#)(d)(2).

Therefore, based on the above, Taxpayer's protest of the assessment of use tax on Taxpayer's use of the labels is denied.

FINDING

Taxpayer's protest of use tax due on the basis of the industrial production exemptions is sustained in part and denied in part, as provided above.

II. Use Tax – Packaging Exemption.

Taxpayer protests the imposition of use tax on certain items used in its packaging process.

(1) Returnable Packaging

Taxpayer protests the assessment of use tax on some "returnable containers" that it states are "used as enclosures for the sale of our [m]anufactured [p]roduct." Taxpayer refers to IC § 6-2.5-5-9(b) in support of its protest. The version of IC § 6-2.5-5-9 in effect for the years at issue in this protest states:

(a) As used in this section, "returnable containers" means containers customarily returned by the buyer of the contents for reuse as containers.

(b) Sales of returnable containers are exempt from the state gross retail tax if the transaction constitutes selling at retail as defined in [IC 6-2.5-4-1](#) and if the returnable containers contain contents.

(c) Sales of returnable containers are exempt from the state gross retail tax if the containers are transferred empty for the purpose of refilling.

(d) Sales of wrapping material and empty containers are exempt from the state gross retail tax if the person acquiring the material or containers acquires them for use as nonreturnable packages for selling the contents that he adds.

(Emphasis added).

[45 IAC 2.2-5-16](#) elaborates on the above statute:

(a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, **and returnable containers containing contents sold in a sale constituting selling at retail** and returnable containers sold empty for refilling.

(b) In general the gross proceeds from the sale of tangible personal property in a transaction of a retail merchant constituting selling at retail are taxable. This regulation [[45 IAC 2.2](#)] provided an exemption for wrapping materials and containers.

(c) General rule. The receipt from a sale by a retail merchant of the following types of tangible personal property are exempt from state gross retail tax:

(1) Nonreturnable containers and wrapping materials including steel strap and shipping pallets to be used by the purchaser as enclosures for selling tangible personal property.

(2) Deposits for returnable containers received as an incident to a transaction of a retail merchant constituting selling at retail.

(3) Returnable containers sold empty for refilling.

(d) Application of general rule.

(1) Nonreturnable wrapping material and empty containers. To qualify for this exemption, nonreturnable wrapping materials and empty containers must be used by the purchaser in the following way:

(A) The purchaser must add contents to the containers purchased; and

(B) The purchaser must sell the contents added.

(2) Returnable containers sold at retail with contents. To qualify for this exemption, the returnable

containers must be:

- (A) Sold in a taxable transaction of a retail merchant constituting selling at retail; and**
- (B) Billed as a separate charge by the retail merchant to his customer. If there is a separate charge for such containers, the sale of the container is exempt from tax under this regulation [45 IAC 2.2].**

(3) Returnable containers sold empty. To qualify for this exemption the returnable container must be resold with the purpose of refilling. The sale of returnable containers to the original or first user thereof is taxable.

(e) Definitions.

(1) Returnable containers. As used in this regulation [45 IAC 2.2], the term returnable container means containers customarily returned by the buyer of the contents for reuse as containers.

(2) Nonreturnable containers. As used in this regulation [45 IAC 2.2], the term "nonreturnable containers" means all containers which are not returnable containers.

(Emphasis added).

In order to qualify for the packaging exemption, even assuming Taxpayer has sufficiently demonstrated that the subject packaging is indeed (1) sold at retail in a taxable transaction, (2) with contents, and (3) the packaging must be billed as a separate charge to the customer. 45 IAC 2.2-5-16(d)(2). Taxpayer has not presented documentation to show how the returnable packages are billed.

Therefore, based on the above and without additional documentation, Taxpayer's protest of the assessment of use tax on the subject packaging is denied.

(2) Non-Returnable Packaging/Wrapping Materials

Taxpayer protests the assessment of use tax on Taxpayer's use of certain pallets and/or wrapping materials. Taxpayer states that the "[p]allets are used as non returnable wrapping materials and shipping pallets that are used as enclosures for selling our product."

Presumably Taxpayer is relying on IC § 6-2.5-5-9(d) in its protest of the assessment of use tax on these items. Again, the version of IC § 6-2.5-5-9 in effect for the years at issue in this protest states:

(a) As used in this section, "returnable containers" means containers customarily returned by the buyer of the contents for reuse as containers.

(b) Sales of returnable containers are exempt from the state gross retail tax if the transaction constitutes selling at retail as defined in IC 6-2.5-4-1 and if the returnable containers contain contents.

(c) Sales of returnable containers are exempt from the state gross retail tax if the containers are transferred empty for the purpose of refilling.

(d) Sales of wrapping material and empty containers are exempt from the state gross retail tax if the person acquiring the material or containers acquires them for use as nonreturnable packages for selling the contents that he adds.

(Emphasis added).

45 IAC 2.2-5-16 elaborates on the above statute:

(a) **The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added,** and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers sold empty for refilling.

(b) In general the gross proceeds from the sale of tangible personal property in a transaction of a retail merchant constituting selling at retail are taxable. This regulation [45 IAC 2.2] provided an exemption for wrapping materials and containers.

(c) General rule. The receipt from a sale by a retail merchant of the following types of tangible personal property are exempt from state gross retail tax:

(1) Nonreturnable containers and wrapping materials including steel strap and shipping pallets to be used by the purchaser as enclosures for selling tangible personal property.

(2) Deposits for returnable containers received as an incident to a transaction of a retail merchant constituting selling at retail.

(3) Returnable containers sold empty for refilling.

(d) Application of general rule.

(1) Nonreturnable wrapping material and empty containers. To qualify for this exemption, nonreturnable wrapping materials and empty containers must be used by the purchaser in the following way:

(A) The purchaser must add contents to the containers purchased; and

(B) The purchaser must sell the contents added.

(2) Returnable containers sold at retail with contents. To qualify for this exemption, the returnable containers must be:

(A) Sold in a taxable transaction of a retail merchant constituting selling at retail; and

(B) Billed as a separate charge by the retail merchant to his customer. If there is a separate charge for such containers, the sale of the container is exempt from tax under this regulation [45 IAC 2.2].

(3) Returnable containers sold empty. To qualify for this exemption the returnable container must be resold with the purpose of refilling. The sale of returnable containers to the original or first user thereof is taxable.

(e) Definitions.

(1) Returnable containers. As used in this regulation [45 IAC 2.2], the term returnable container means containers customarily returned by the buyer of the contents for reuse as containers.

(2) Nonreturnable containers. As used in this regulation [45 IAC 2.2], the term "nonreturnable containers" means all containers which are not returnable containers.

(Emphasis added).

Apart from Taxpayer's say-so, Taxpayer has not provided any specific documentation of how these pallets and wrapping materials are used in order for the Department to determine whether or not the use of these materials is exempt from use tax.

Therefore, based on the above and without further documentation, Taxpayer's protest of the assessment of use tax on the subject pallets and wrapping materials is denied.

FINDING

Taxpayer's protest is respectfully denied.

III. Tax Administration – Negligence Penalty.

DISCUSSION

The Department issued ten percent negligence penalties for the tax years in question. Taxpayer protests the imposition of the penalties. The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides "a person that . . . incurs, upon examination by the department, a deficiency that is due to negligence . . . is subject to a penalty."

The Department refers to [45 IAC 15-11-2\(b\)](#), which 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\(c\)](#), 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.

Taxpayer has not provided any rationale for not remitting use tax on the contested items other than basically everything it purchases is necessary for its production process. Taxpayer had been previously audited by the Department and therefore had some understanding of the parameters of the industrial production exemptions. Taxpayer has not met its burden of proof to show that the deficiencies they incurred are due to reasonable cause and therefore the deficiencies are subject to a penalty under IC § 6-8.1-10-2.1(a).

FINDING

Taxpayer's protest of the penalty is respectfully denied.

SUMMARY

Taxpayer is sustained in part and denied in part on its protest of the imposition of use tax based on the industrial production exemptions.

Taxpayer is denied on its protest of the imposition of use tax based on the packaging and wrapping materials exemptions.

Taxpayer is denied on its protest of the imposition of the ten-percent penalty.

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