DEPARTMENT OF STATE REVENUE

04-20130513.LOF

Letter of Findings: 04-20130513
Sales and Use Tax
For the Years 2010, 2011, and 2012

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 This document is effective as of its date of publication and remains in effect until the date it is superseded by the publication of another document in the Indiana Register.

ISSUE

I. Sales & Use Tax - Imposition.

Authority: IC § 6-2.5-1-1 et seq.; IC § 6-2.5-1-2; IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-3-2; 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; 45 IAC 2.2-5-8; 45 IAC 2.2-5-12; 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); Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); Rhoade v. Indiana Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); Indiana Dep't of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282 (Ind. Tax Ct. 1999); Mynsberge v. Indiana Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); Harlan Sprague Dawley, Inc. v. Indiana Dept. of State Revenue, 605 N.E.2d 1222 (Ind. Tax Ct. 1992); Hyatt Corp. v. Dep't of State Revenue, 695 N.E.2d 1051 (Ind. Tax Ct. 1998); Anheuser-Busch Brewing Ass'n v. United States, 207 U.S. 556 (1908); Indiana Creosoting Co. v. McNutt, 5 N.E.2d 310 (Ind. 1936); Mechanics Laundry & Supply, Inc. v. Indiana Dep't of State Revenue, 650 N.E.2d 1223 (Ind. Tax Ct. 1995); White River Envtl. P'ship v. Indiana Dep't of State Revenue, 694 N.E.2d 1248 (Ind. Tax Ct. 1998); Indiana Dep't of Revenue v. Interstate Warehousing, Inc., 783 N.E.2d 248 (Ind. 2003).

Taxpayer protests the assessment of tax on purchases of tangible personal property.

STATEMENT OF FACTS

Taxpayer is in the bookbinding business, which operates various facilities in Indiana. In addition to a "New Book Production," Taxpayer offers "Library Binding" services to its customers, which includes libraries or similar institutions. Taxpayer receives "monographs (books) and periodicals (magazines) from libraries and create[s] new bindings for both." The steps for "Library Binding" process "consist of (1) altering the textblock (pages) by disbinding, adding new endpapers and creating new page affixing with much longer lasting adhesive and/or thread; (2) [making] a new cover; and (3) the attachment of the new cover to the altered textblock using much longer lasting adhesive."

In 2013, the Indiana Department of Revenue ("Department") conducted a sales/use tax audit of Taxpayer's business records and tax returns for the 2010, 2011, and 2012 tax years. Pursuant to the audit, the Department found that Taxpayer purchased tangible personal property, including, but not limited to, "thread used to bind periodicals," "adhesive used for monographs," and office supplies, used during the course of its business activities without paying sales tax or self-assessing use tax. As a result, the Department assessed Taxpayer additional use tax and statutory interest on those purchases. Nevertheless, the Department's audit abated the negligence penalty.

Taxpayer protested the assessment of use tax on its purchases of the "thread used to bind periodicals" and the "adhesive used for monographs" ("Items at Issue") that were used during the Library Binding process. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales & Use Tax - Imposition.

DISCUSSION

The Department's audit assessed Taxpayer use tax on its purchases of the Items at Issue because Taxpayer

neither paid sales tax nor self-assessed and remitted the use tax on the Items at Issue. Taxpayer, to the contrary, claimed that its purchases and use of the Items at Issue were exempt pursuant to 45 IAC 2.2-5-12. The primary source of this exemption is outlined in IC § 6-2.5-5-5.1(b).

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). Thus, the taxpayer is required to provide documentation explaining and supporting its challenge that the Department's assessment is wrong. Poorly developed and non-cogent arguments are subject to waiver. Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 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). The use tax is functionally equivalent to the sales tax. See Rhoade 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. Rhoade, 774 N.E.2d at 1048; 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. Rhoade, 774 N.E.2d at 1047 - 1050 (explaining that, generally, states impose a use tax to prevent the erosion of the state's tax base when its residents make purchases in other states). To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. IC § 6-2.5-3-2(a); USAir, Inc., 623 N.E.2d at 468. 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) and (c); IC § 6-2.5-3-2(a) and (b).

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, unless specifically exempt by a statute. 45 IAC 2.2-5-8(a). There are various tax exemptions available as outlined in IC § 6-2.5-5. The legislative intent to exempt the purchase of equipment used and material consumed in the production of other tangible personal property is "to encourage industrial growth by allowing an exemption for items closely connected with the production of goods," Harlan Sprague Dawley, Inc. v. Indiana Dept. of State Revenue, 605 N.E.2d 1222, 1228 (Ind. Tax Ct. 1992) (citing General Motors Corp. v. Indiana Dep't of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991), aff'd 599 N.E.2d 588 (Ind. 1992)), and also "to mitigate the effect of tax pyramiding," Hyatt Corp. v. Dep't of State Revenue, 695 N.E.2d 1051, 1056 (Ind. Tax Ct. 1998). "Tax pyramiding occurs in the sales and use tax context where a tax is levied upon a tax." Hyatt Corp., 695 N.E.2d at 1056.

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 (quoting Conklin v. Town of Cambridge City, 58 Ind. 130, 133 (1877)). Thus, in applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dep't of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988); See also Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); Mynsberge v. Indiana Dep't of State Revenue, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999).

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**).

45 IAC 2.2-5-12, in relevant part, explains:

> (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.
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> (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.
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> (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.

Additionally, through statutory interpretation, courts have further addressed what constitutes "manufacture" and therefore the statutory exemptions apply. To qualify for "manufacture," a change in an article must be substantial–a "transformation." Anheuser-Busch Brewing Ass'n v. United States, 207 U.S. 556, 562 (1908) (holding that the brewer was not a manufacturer of corks although it carefully examined, sorted, cut, washed, bathed, steamed, and dried the corks to seal its beer bottle after the corks were imported.) "Manufacture implies a change, but every change is not manufacture, and yet every change in an article is the result of treatment, labor and manipulation. But something more is necessary . . . . There must be transformation; a new and different article must emerge, having a distinctive name, character or use." Id (internal quotations omitted).

Furthermore, a manufacturer "is engaged in the business of working raw materials into wares suitable for use, (or) . . . gives new shapes, new qualities, new combinations to matter which has already gone through some artificial process. A manufacturer prepares the original substance for use in different forms." Indiana Creosoting Co. v. McNutt, 5 N.E.2d 310, 314 (Ind. 1936) (quoting State v. American Creosote Works, 112 So. 412, 413 (La. 1927)). A manufacturer is one, who "makes to sell, and stands between the original producer and the dealer, or first consumers, depending for his profit on the labor which he bestows on the raw material." Indiana Creosoting Co., 5 N.E.2d at 314; See also Mechanics Laundry & Supply, Inc. v. Indiana Dep't of State Revenue, 650 N.E.2d 1223, 1229-30 (Ind. Tax Ct. 1995) (holding that laundering of soiled textiles did not constitute production and thus the cleaning supplies, water, gas, electricity, and other products consumed during the laundering of soiled textiles were not exempt); White River Envtl. P'ship v. Indiana Dep't of State Revenue, 694 N.E.2d 1248, 1250-51 (Ind. Tax Ct. 1998) (holding that the equipment used in the wastewater treatment process was not exempt because "the 'products' of the wastewater treatment process (clean water, ash, and sludge) were not sold to others"); Indiana Dep't of Revenue v. Interstate Warehousing, Inc., 783 N.E.2d 248, 249-52 (Ind. 2003) (holding that the electricity used to maintain the refrigeration system was not exempt because the taxpayer did not market the "liquid ammonia" for sale and thus did not create a "distinct marketable good," although it used the electricity to transform "the ammonia from gas to liquid").

In short, to claim the exemption under IC § 6-2.5-5-5.1(b) and 45 IAC 2.2-5-12, a taxpayer must demonstrate that it produces or manufactures tangible personal property for sale. Only when a taxpayer (1) engages in the business of producing and manufacturing marketable goods for sale and (2) directly uses or consumes the tangible personal property in direct production of the marketable goods, its purchases and use of tangible personal property which are consumed in the process are exempt.

Taxpayer, in this instance, claims that its purchases and use of the Items at Issue were exempt because the Items at Issue were consumed in its Library Binding process which makes the periodicals and monographs more durable. Taxpayer further, referencing an "Order on Refund," asserts that the Department previously has concluded that the Items at Issue were exempt. To support its protest, Taxpayer submitted additional documentation, including a copy of the "Order on Refund."

Upon review, the "Order on Refund" was intended to address various issues which arose from a refund denial for tax years 1999 through 2002 pursuant to the then applicable statutes, regulations, and case law. Taxpayer in this case, however, protests the audit assessment for the tax years 2010 through 2012. The taxpayer in the "Order on Refund," as Taxpayer explains, subsequently went through reorganization due to a change of ownership. Additionally, since 2002, the General Assembly has added or amended the statutes as needed; the courts have further clarified and refined the applicability of the exemptions as taxpayers presented their challenges in courts.

Thus, from 2002 through 2012, in light of the changes among facts and applicable laws, Taxpayer's reliance solely on that "Order on Refund" is inappropriate.

Even if, for the purpose of argument, the Department accepts the conclusion of the "Order on Refund," the Items at Issue used in the Library Binding process remain taxable. The "Order on Refund" is consistent with the audit's findings and Taxpayer's reliance on the "Order on Refund" is misplaced. Specifically, the "Order on Refund" does not exempt materials, namely Items at Issue, used in processing the magazines and monographs. The "Order on Refund," in relevant part, states that:

> **Periodical Production**
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> . . .
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> When taxpayer binds the magazines, it does nothing to change the nature of the magazine. **Cutting off the spine and gluing or stitching a cover on it is not enough to constitute a new product.** But, taxpayer does manufacture the cover to the specifications of [its customers]. This cover is not in existence before taxpayer's customer requests it. By creating a customer-made cover for its customers, taxpayer has manufactured a new piece of tangible personal property for its customer. However, **to the extent that taxpayer places the cover on the magazines, no new tangible personal property is created**.
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> Therefore, taxpayer is sustained to the extent of equipment used to produce the cover. Taxpayer is respectfully **denied with regard to materials used in processing the magazines.**
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> **Monographs**
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> . . .
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> Taxpayer is sustained to the extent of equipment and materials used to produce the cover. Taxpayer is respectfully **denied with regard to equipment used in processing the old books.**
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> (**Emphasis is original** and **emphasis added**).

Taxpayer explains that its Library Binding process makes books or magazines more durable as those books and magazines are circulated among patrons of its customers. Upon receiving the periodicals and/or monographs from its customers, Taxpayer disbands the pages, adds new endpapers (or replaces damaged papers, if necessary), attaches new pages with the Items at Issue and attaches a new cover with the Items at Issue. Aside from trimming excess endpapers and gluing new endpapers and covers to the periodicals or monographs, Taxpayer does not transform them into new products; the periodicals or monographs do not undergo a substantial change. At best, the binding process makes the periodicals or monographs, with new covers, more durable to withstand the wear and tear, but nothing more. Also, Taxpayer does not sell the periodicals or monographs and thus produces no marketable goods in its Library Binding process. Thus, Taxpayer is not a manufacturer as to its Library Binding process and the Items at Issue used during that process are not exempt.

Given the totality of circumstances, in the absence of other documentation, the Department is not able to agree with Taxpayer that it has met its burden to demonstrate that the Department's proposed assessment is wrong. Since sales tax was not paid on the Items at Issue, the use tax is properly imposed.

FINDING

Taxpayer's protest on the purchases of the Items at Issue is respectfully denied.

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