DEPARTMENT OF STATE REVENUE

04-20140435.LOF

Letter of Findings: 04-20140435
Sales and Use Tax
For the Years 2010-2012

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires the publication of this document in the Indiana Register. The 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 This document is effective on its date of publication and remains in effect until the date it is superseded by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Manufacturer conducted business within the state. Manufacturer was required to collect sales tax on all items delivered to Indiana. Manufacture did not demonstrate that "Mini Luber" and "Mighty Lube" brushes, the printer maintenance agreement, and a forklift directly affected the direct production of displays. Manufacturer failed to provide that any sales tax was paid on diesel fuel. Finally, manufacturer failed to show that it paid use tax on artwork and tooling invoiced to customer.

ISSUES

I. Sales Tax - Freight Invoice.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-4-1; IC § 6-8.1-5-1(c); IC § 6-2.5-13-1; 45 IAC 2.2-3-14(2) ; Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014).

Taxpayer argues that it owed sales tax on only a portion of the assessed amount because only four taxable items were ultimately shipped to Indiana.

II. Use Tax - Manufacturing Exemption.

Authority: IC § 6-2.5-3-2; IC § 6-2.5-5-3; 45 IAC 2.2-5-8; Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988).

Taxpayer maintains that the "Mini Lubers" and "Mighty Lube" brushes, printer maintenance agreement, and forklifts are exempt manufacturing equipment.

III. Use Tax - Diesel Fuel.

Authority: 45 IAC 2.2-7-3.

Taxpayer argues that it provided enough documentation to show that sales tax was paid on diesel fuel at the pump.

IV. Use Tax - Artwork and Tooling.

Authority: IC § 6-2.5-1-5; IC § 6-2.5-4-1; IC § 6-2.5-3-6.

Taxpayer maintains that it paid sales tax and any remaining sales tax due was passed onto the purchaser.

V. Use Tax - Audit Methodology.

Authority: IC § 6-8.1-3-12(b); IC § 6-8.1-4-2; IC § 6-8.1-5-1.

Taxpayer maintains that these transactions are not recurring transactions and therefore should be removed from

the statistical sample.

STATEMENT OF FACTS

Taxpayer is an out-of-state manufacturing company conducting business in the state. Taxpayer operates plants and a warehouse within the state. The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records. Due to the volume of Taxpayer's invoices, the Department used "statistical sampling methodology to estimate the additional purchases subject to sales and use tax. . . ." Taxpayer was given the opportunity to review the exclusions and present any other exclusion that might distort the projected results. The Department also found instances where Taxpayer did not collect and remit sales and accrued use tax but did not pay those amounts to the state.

Taxpayer disagreed with portions of the assessment and submitted a protest to that effect. Prior to the hearing, the Department agreed to remove the Computer Assisted Software from the assessment.

An administrative hearing was conducted to address the remaining protest. During the hearing, Taxpayer explained the basis for its protest. This Letter of Finding results. Further facts will be provided as required.

DISCUSSION

I. Sales Tax - Freight Invoice.

As a threshold issue, it is the Taxpayers' responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Further, [W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014). Thus, interpretations of Indiana tax law contained within this decision, as well as the preceding audit, are entitled to deference.

The audit assessed additional sales tax on items Taxpayer shipped to its customers in Indiana.

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). IC § 6-2.5-4-1(a) states that:

> The gross retail income received from selling at retail is only taxable under this article to the extent that the income represents:
> (1) the price of the property transferred, without the rendition of any service; and
> (2) except as provided in subsection (g), any bona fide charges which are made for preparation, fabrication, alteration, modification, finishing, completion, delivery, or other service performed in respect to the property transferred before its transfer and which are separately stated on the transferor's records.

In other words, sales tax is imposed on retail transactions that occur within Indiana. IC § 6-2.5-13-1 is the sourcing statute for retail merchants with retail transactions occurring in Indiana. IC § 6-2.5-13-1, in relevant part, provides:

> (a) As used in this section, the terms "receive" and "receipt" mean:
> (1) taking possession of tangible personal property;
> (2) making first use of services; or
> (3) taking possession or making first use of digital goods;
> whichever comes first. The terms "receive" and "receipt" do not include possession by a shipping company on behalf of the purchaser.
> . . .
> (d) The retail sale, excluding lease or rental, of a product shall be sourced as follows:
> (1) When the product is received by the purchaser at a business location of the seller, the sale is sourced to that business location.
> (2) When the product is not received by the purchaser at a business location of the seller, the sale is

> sourced to the location where receipt by the purchaser (or the purchaser's donee, designated as such by the purchaser) occurs, including the location indicated by instructions for delivery to the purchaser (or donee), known to the seller.

Accordingly, if an out-of-state seller delivered the property to Indiana, then sales tax needed to be collected and remitted because those transactions would be Indiana retail transactions that are subject to Indiana sales tax.

The Department found that sales tax should have been collected on an invoice where Taxpayer delivered a large amount of displays to an Indiana warehouse owned by Taxpayer. Taxpayer argues that only four displays were ultimately shipped to Indiana stores, and it should only be taxed on those four displays. Taxpayer provided a spreadsheet with a breakdown of customer and location of each display sold within the invoice to show that not all the items were sold to Indiana stores. However, all the items listed on the invoice were shipped to the Indiana warehouse. Taxpayer maintains that the warehoused items were then shipped to various locations stated in the spreadsheet provided by Taxpayer. However, the delivery address on the invoice was in Indiana. In fact Taxpayer admits the items were delivered to the Indiana warehouse. According to Taxpayer it takes approximately two months for the items to be shipped from the warehouse to the ultimate destination. Taxpayer did not provide any source documentation, such as bills of lading, purchase agreement's subsequent invoice, etc. to demonstrate that the items were not "delivered" in Indiana. Taxpayer's protest is denied for failing to demonstrate that only four displays were delivered to Indiana.

FINDING

Taxpayer's protest is denied.

DISCUSSION

II. Use Tax - Manufacturing Exemption.

Indiana imposes a 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). Retail sales tax and use tax sometimes are complementary, but also separate taxes. When sales tax is paid a credit is provided against the use tax due. IC § 6-2.5-3-5. Thus, if sales tax is not paid, then use tax is due.

IC § 6-2.5-5-3(b) provides an exemption from sales tax for "manufacturing machinery, tools, and equipment . . . if the person acquiring the property acquires it for direct use in the direct production [or] manufacture . . . of other tangible personal property." Under 45 IAC 2.2-3-14(2) exemptions that also apply to IC § 6-2.5-5 also apply to use tax.

Taxpayer maintains that it purchased items that qualify as exempt maintenance equipment under IC § 6-2.5-5-3.

In applying any tax exemption, "[t]he general rule is that tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

45 IAC 2.2-5-8(b) and IC § 6-2.5-5-3 like all tax exemption provisions, are strictly construed against exemption from the tax. Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999). Nevertheless, the Department is well aware of the countervailing rule that a "statute must not be construed so narrowly that it does not give effect to legislative intent because the intent of the legislature embodied in a statute constitutes the law." General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991).

45 IAC 2.2-5-8(a) states that "[i]n 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." However, 45 IAC 2.2-5-8(b) notes:

> The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property.

Property acquired for "direct use in the direct production" is defined in 45 IAC 2.2-5-8(c) as "manufacturing

machinery, tools, and equipment to be directly used by the purchaser in the production process" that have "an immediate effect on the article being produced." Property has "an immediate effect" when it becomes "an essential and integral part of the integrated process which produces tangible personal property." 45 IAC 2.2-5-8(c).

In addition, 45 IAC 2.2-5-8(g) provides that:

> 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.

Taxpayer claims that its purchases of "Mini Lubers" and "Mighty Lube" brushes, printer maintenance agreement, and forklifts were exempt manufacturing equipment.

A. "Mini Lubers" and "Mighty Lube" Brushes.

The Depertment *[sic]* determined that the "Mini Luber" system was treated as an add-on to the conveyor system and reduced wear and tear on the equipment. Taxpayer explained that the "Mini-Lubers" are used on every electric motor located on the Powder Coat line. The "Mini-Lubers" supply a set amount of lube 24 hours a day to the line's motor, so that the line can move and function to produce the manufactured product. "Mighty Lube" brushes are used on the "Mighty Lube" machine. It is used to paint the conveyor system with lubricant to keep the line running. According to Taxpayer, without the use of the "Mini Lubers" and "Mighty Lube" brushes the conveyor system would not run properly.

Taxpayer argues that the "Mini Lubers" and "Mighty Lube" brushes are essential to their manufacturing process and are used twenty-four hours a day. Taxpayer maintains that the equipment constitutes as an essential and integral part of the integrated production process and is therefore exempt.

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. 45 IAC 2.2-5-8(h)(1).

The "Mini Luber" and "Might Lube" brushes are used to lubricate conveyor lines; neither item paints the actual product nor does either one create a product. Instead the "Mini Lubers" and "Might Lube" brushes prevented wear and tear on the machinery. Therefore, according to 45 IAC 2.2-5-8(h)(1) preventive maintenance of machinery is subject to tax.

Taxpayer has not met its burden demonstrating that "Mini Lubers" and "Mighty Lube" brushes are an essential and integral part of its manufacturing process. Taxpayer's protest of the imposition of use tax on the "Mini Lubers" and "Mighty Lube" brushes is denied.

B. Printer Maintenance Agreement.

The Department determined that the printer maintenance was not used in the production of Taxpayer's products. Taxpayer claims that the full service maintenance agreement for industrial printers in the carton department is exempt stating it is an essential and integrated part of the production process.

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.

As stated above, 45 IAC 2.2-5-8(c) requires that exempt equipment must have an immediate effect on the product being produced.

Pursuant to 45 IAC 2.2-5-8(h)(2) "[r]eplacement parts, used to replace worn, broken, inoperative, or missing parts

or accessories on exempt machinery and equipment, are exempt from tax." Accordingly, a "maintenance agreement" purchased for the software for the printer would be tax exempt to the extent that the printer is exempt.

According to Taxpayer, the printer prints labels and wording directly onto the flat box containers. However, the printing of bar code labels that subsequently are placed on packaging occurs prior to the boxes being introduced into the package process and is therefore, considered a pre-production activity. The audit determined, in accordance with the statute, that the printer had no direct or immediate effect on Taxpayer's production, and is therefore not exempt. The printing of labels is pre-production; the displays had not yet reached the point of "the first point of operation or activity consisting part of the integrated production process." 45 IAC 2.2-5-8(a). Therefore, since the printer is not exempt the maintenance agreement on the printer also not exempt.

Taxpayer's protest to the imposition of use tax for the maintenance agreement on the printer is denied.

C. Forklifts.

Taxpayer uses forklifts in its production process. Taxpayer protests that one of the plant's forklifts has a higher exemption percentage than what the auditor gave Taxpayer.

45 IAC 2.2-5-8(f) provides:

> (1) Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.
> (2) Tangible personal property used for moving finished goods from the plant after manufacture is subject to tax.
> (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.
> (4) Transportation equipment used to transport work-in-process, semi-finished, or finished goods between plants is taxable, if the plants are not part of the same integrated production process.

The auditor calculated exemption percentages based upon the forklifts used in the transportation of work-in-process vs. raw materials, furnished goods, or other activities outside the production. The auditor calculated an average percentage for each branch/cost center to account for movement of forklifts and other lift type equipment between different plant areas. The audit determined 19[percent] exemption for Taxpayer's forklifts.

Taxpayer conducted its own "audit" of their forklift usage at the specified location and determined that there should be a 32 [percent] exemption, at minimum. Taxpayer based its conclusion on interviewing a production manager for that plant; the manager broke down the tasks forklifts did at that particular location. However this is not supplemented by additional information to overturn the audit's findings. Additionally, Taxpayer's conclusions were based upon incorrect determinations about when taxable versus exempt activities were conducted. For example, Taxpayer stated that the movement of raw materials should be exempt. Taxpayer has not met their burden and therefore, its protest is denied.

FINDINGS

Taxpayer's protest on the imposition of use tax on the "Mini Lubers" and "Might Lube" brushes, printing maintenance agreement, and forklift is denied.

DISCUSSION

III. Use Tax - Diesel Fuel.

Taxpayer purchased fuel through metered pumps; Taxpayer paid by credit card. Taxpayer believed that the pump price of diesel sold through metered pumps included sales tax. During the original audit Taxpayer could not provide documentation showing the amount of sales tax paid.

It appears Taxpayer is relying on 45 IAC 2.2-7-3 which states that the retail merchant selling gasoline which is dispensed from a metered pump must collect the state gross retail tax prescribed in Regulation 6-2.5-7-3(010) [45 IAC 2.2-7-2] even if the transaction is exempt from taxation under IC § 6-2.5-5-5. However, this statute does not apply to diesel fuel; and sellers are allowed to have exempt pumps for diesel fuel.

Taxpayer supplied purchase summary reports which did not demonstrate that sales tax was paid on diesel purchases. Furthermore, Taxpayer failed to provide source documents such as, invoices and other vendor documents which demonstrated that sales tax was paid on the diesel fuel purchases in question.

FINDINGS

Taxpayer's protest is denied.

DISCUSSION

IV. Use Tax - Artwork and Tooling.

The Department determined that Taxpayer did not have an exemption certificate for the Artwork and Tooling itemized in customer's invoice. The invoice calculated that Indiana sales tax was due on only part of the order. Taxpayer did not include artwork and tooling in the sales tax calculation. Taxpayer bought the artwork and tooling to incorporate into the customer's display. Taxpayer argued that it passed the cost of sales tax to the customer.

Taxpayer is a retail merchant as defined in IC § 6-2.5-4-1 which states "that a person is retail merchant making a retail transaction when the person engages in selling at retail." A retail merchant is an agent for Indiana and is responsible for collecting and remitting sales tax for the state. IC § 6-2.5-3-6.

Indiana defines gross retail income in IC § 6-2.5-1-5, which states:

> (a) Except as provided in subsection (b), "gross retail income" means the total amount of consideration, including cash, credit, property, and services, for which tangible personal property is sold, leased, or rented, valued in money, whether received in money or otherwise, without any deduction for:
> (1) the seller's cost of the property sold;
> (2) the cost of materials used, labor or service cost, interest, losses, all costs of transportation to the seller, all taxes imposed on the seller, and any other expense of the seller;
> (3) charges by the seller for any services necessary to complete the sale, other than delivery and installation charges . . . .

According, IC § 6-2.5-1-5 the seller's cost of materials are included in "gross retail income" and thus taxable. Therefore, Taxpayer has neither provided documentation to show that customer paid sales tax on artwork and tooling nor, provided documentation to show that these items were exempt.

FINDINGS

Taxpayer's protest to the imposition of sales tax on the itemization of artwork and tooling on customer's invoice is denied.

V. Use Tax - Audit Methodology.

DISCUSSION

During the audit, the Department determined the audit be conducted using a statistical sample of Indiana sales transactions and projection of tax due based on the resulting rate of error. The audit sample was drawn from all of Taxpayer's expense purchases. The audit determined that all of the items that were expensed rather than capitalized were included and must remain in the sample. Taxpayer protests the statistical sample and the particular methodology employed in the original audit.

It should be noted that the audit acted entirely within its authority to conduct a "statistical sampling" of Taxpayer's transactions and to propose an assessment based on that sampling. The authority to do so is found at IC § 6-8.1-3-12(b) which states:

> The department may audit any returns with respect to the listed taxes using statistical sampling. If the taxpayer and the department agree to a sampling method to be used, the sampling method is binding on the taxpayer and the department in determining the total amount of additional tax due or amounts to be refunded.

The original audit report describes the process by which the audit made its original determination. The taxpayer was set up to have a statistical sample of their January 1, 2010, through December 31, 2012, use tax purchases.

The transactions are the purchases other than the assets.

The audit made its determination as to unreported purchases subject to use tax as follows:

> The information provided was examined and an error percentage was established for the accounts involved. The error percentage was applied to the account balances involved to establish use tax adjustment amounts.

The Department may, of course, examine the books, records, or other data bearing on the correctness of the returns and to arrive at a rational conclusion based on those records. IC § 6-8.1-4-2. As noted above, 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).

Taxpayer argues that these purchases were a onetime purchase and should be excluded from the sample. Taxpayer asserts in its protest that its purchase of test coils, battery chargers, and ball bearings were made for capital asset projects should not be included in any sample. Taxpayer maintains the items should have been independently reviewed and assessed like its capital assets.

Taxpayer further maintains that the items are non-recurring purchases that should have been treated as extraordinary items and therefore should also be included with a review of capital purchases.

However, the design of a statistical sample largely eliminates the issue of extraordinary transactions skewing the sample results. Stratification and the opportunity for all records in the population to be selected for review addresses the concerns of projecting extraordinary items that are inherent in block samples. The primary means of evaluating whether or not results of a STAT sample are acceptable in the precision calculations. For this particular audit at a 90[percent] confidence interval the achieved precision is 18.22[percent] or $14,756 tax. Accordingly the Department is 90[percent] confident that the actual tax due lies between the Department's goal of achieved precision of 20[percent] or less.

Moreover while these items may seem unique or non-reoccurring to Taxpayer because they were bought for a particular capital asset project, Taxpayer had multiple capital asset project expenses. Taxpayer argues that since these items are unique expenses rather than capitalized they must never be in the sample. These expenses do not appear to be any different than any other expenses that Taxpayer uses in its business.

The Department agrees that a recalculation of taxpayer's sales and use tax liabilities could very well result in a different result than the one reached by the audit. However, an administrative hearing is not the appropriate forum by which to explore variances and suggest alternative methodologies. Having protested the audit results, it is the taxpayer's burden of demonstrating that the sampling method is wrong, not that an alternative methodology would produce a different result. Taxpayer has failed to demonstrate clear error on the part of the audit.

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

The Department concludes that Taxpayer did not provide enough documentation to determine that only four display items were sold and delivered to Indiana stores therefore its protest on the imposition of sales tax for all displays sold within the invoice is denied. Taxpayer's protest on the imposition of use tax of "Mini Luber" and "Mighty Lube" brushes, printer maintenance agreement, and forklifts usage is denied. Taxpayer's protest on the imposition of use tax on its diesel fuel purchases is denied. Finally, Taxpayer's protest on the imposition of sales tax on the artwork and tooling itemized on its customer's invoice is denied. Taxpayer has failed to demonstrate clear error on the part of the audit methodology and its protest on the imposition of use tax on capital assets is denied.

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