DEPARTMENT OF STATE REVENUE

04-20150268.LOF

Letter of Findings Number: 04-20160268
Sales Tax and Use Tax
For Tax Years 2011-12

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 This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Business did not produce documentation and explanation showing that certain purchases were eligible for the agricultural exemption or the manufacturing exemption. Therefore, those purchases were not exempt. Business did not prove the Department's methodology incorrect.

ISSUES

I. Sales Tax–Imposition.

Authority: IC § 6-2.5-2-1; IC § 6-8.1-5-1; Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Indiana Dept. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); 45 IAC 2.2-3-4; 45 IAC 2.2-5-3.

Taxpayer protests the imposition of sales tax on certain transactions.

II. Use Tax–Imposition.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-5-2; IC § 6-2.5-5-3; IC § 6-8.1-5-1; IC § 15-12-1-1; IC § 15-12-1-10; Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Indiana Dept. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Wendt LLP v. Indiana Dept. of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Merchandise Warehouse v. Indiana Dept. of State Revenue, 67 N.E.3d 666 (Ind. Tax 2017); 45 IAC 2.2-3-4; 45 IAC 2.2-5-1; Sales Tax Information Bulletin 9 (January 2016).

Taxpayer protests the imposition of use tax.

III. Tax Administration–Penalties.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of penalties.

STATEMENT OF FACTS

Taxpayer is a limited liability partnership ("LLP") co-operative serving the agricultural industry. As the result of an audit, the Indiana Department of Revenue ("Department") determined that for the tax years 2011 and 2012 ("Tax Years") Taxpayer had not collected and remitted the proper amount of sales tax as a retail merchant and had not paid sales tax or use tax on taxable purchases it made as a consumer. The Department therefore issued proposed assessments for sales tax, use tax, penalties, and interest. Taxpayer protested the imposition of a portion of the sales tax and use tax proposed assessments. Taxpayer also protested the imposition of penalties. Taxpayer paid the proposed assessments and also submitted a claim for refund of a portion of both sales tax and use tax and related penalties. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Sales Tax–Imposition.

DISCUSSION

Taxpayer protests the imposition of sales tax on some of the transactions determined by the Department to be subject to sales tax for the tax years 2011 and 2012. Taxpayer states that the statistical sampling method used by the Department in conducting the audit was fundamentally wrong. The Department based the proposed assessments on a sample and projection method in which the Department selected a randomized sample of transactions to review for sales tax compliance. The percentage of compliance was then applied to total sales over the two tax years. Credit was allowed for sales tax previously remitted. Proposed assessments were made for the difference between the amount of sales tax previously remitted and the amount the Department determined should have been collected and remitted.

As a threshold issue, it is the Taxpayer's 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 Dept. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. 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, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

Sales tax is imposed by IC § 6-2.5-2-1, which 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. (Emphasis added).

Therefore, retail merchants are required to collect sales tax on retail transactions, unless the transaction is exempt from sales tax.

Taxpayer's protest is in regard to the methodology used by the Department in its sample and projection calculations. Specifically, Taxpayer states that it consulted a third party to prepare an evaluation report on the Department's methodology. That report refers to the sample and projection methodology which the Department used for Taxpayer in a prior audit and states that the method used by the Department did not separate sampled transactions into six strata based on dollar amount, but rather only used four strata. Also, the third party states in the report that the sample size per strata is too small. Finally, the third party states in the report that the Department made only one audit adjustment in two separate strata. Taxpayer argues that this is not an acceptable statistical method. The third-party report states that several states other than Indiana have promulgated rules or policies for a minimum number of errors per stratum before projection is allowed. These factors, Taxpayer argues, cause the Department's sample and projection to fail to achieve an "acceptable level of relative precision" which was stated on the Department's audit report.

After review of the sample populations and calculations, the Department does not agree with Taxpayer's protest on this point. As mentioned above, the third party's report only discusses the sample and projection methodology of a prior audit. A fundamental flaw in the third party report is that the sample and projection calculations used in the instant audit clearly use six strata. This is a fundamental difference from the situation discussed in the third party report. Another flaw in the third party report is the report's criticism of the Department's use of only 1,200 samples, which the third party considered too small. A review of the audit report in the instant case and its sample population shows that over 1,500 samples were used. Given that the third party's report only addresses perceived flaws in a prior audit and does not discuss the instant audit, the Department finds that the report is not reliable and in turn finds no benefit to further discussion of the report's merits or conclusions. Since this is Taxpayer's only point of protest regarding the Department's proposed assessments of sales tax, and since the third party report upon which Taxpayer bases its protest is not reliable, Taxpayer has not met the burden imposed by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is denied.

II. Use Tax–Imposition.

DISCUSSION

Taxpayer protests the imposition of use tax on certain purchases it made during the tax years 2011-12. Specifically, Taxpayer states that it was eligible for various exemptions from sales tax and use tax. The Department reviewed capital asset purchases on a transaction-by-transaction basis. For expense purchases, the Department based its determinations on a sample and projection of Taxpayer's purchases during the tax years. Also, the Department determined that, although Taxpayer's customer base primarily consisted of those engaged in agriculture, Taxpayer itself was neither a manufacturer and nor was it engaged in agricultural production. Taxpayer disagrees with the Department's conclusion regarding the taxable status of several capital asset purchases and with several sampled transactions and therefore disagrees with the projection results. Taxpayer's position is that the protested transactions were exempt from sales and use taxes because Taxpayer's activities qualified for either the agricultural exemption or the manufacturing exemption.

As a threshold issue, it is the Taxpayer's 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 Dept. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. 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, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

Sales tax is imposed by IC § 6-2.5-2-1, which 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.

Use tax is imposed by IC § 6-2.5-3-2(a), which states:

> An excise tax, known as the use tax, is imposed 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.

45 IAC 2.2-3-4 further explains:

> Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

Therefore, when tangible personal property is used, stored, or consumed in Indiana, use tax is due unless sales tax was paid at the time of the transaction.

Taxpayer's first point of protest concerns items which it believes qualify for the agricultural exemption. IC § 6-2.5-5-2 states:

> (a) Transactions involving agricultural machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for his direct use in the direct production, extraction, harvesting, or processing of agricultural commodities.
> (b) Transactions involving agricultural machinery or equipment are exempt from the state gross retail tax if:
> (1) the person acquiring the property acquires it for use in conjunction with the production of food and food

ingredients or commodities for sale;
(2) the person acquiring the property is occupationally engaged in the production of food or commodities which he sells for human or animal consumption or uses for further food and food ingredients or commodity production; and
(3) the machinery or equipment is designed for use in gathering, moving, or spreading animal waste.
(Emphasis added).

Also, 45 IAC 2.2-5-1(a) provides:

"Farmers" means only those persons occupationally engaged in producing food or agricultural commodities for sale or for further use in producing food or such commodities for sale. These terms are limited to those persons, partnerships, or corporations regularly engaged in the commercial production for sale of vegetables, fruits, crops, livestock, poultry, and other food or agricultural products. Only those persons, partnerships, or corporations whose intention it is to produce such food or commodities at a profit and not those persons who intend to engage in such production for pleasure or as a hobby qualify within this definition.
"Farming" means engaging in the commercial production of food or agricultural commodities as a farmer.
"To be directly used by the farmer in the direct production of food or agricultural commodities" requires that the property in question must 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 food or an agricultural commodity.

Therefore, in order for a person to acquire agricultural machinery, tools, or equipment exempt from sales and use taxes, the person must acquire the agricultural machinery, tools, or equipment for his direct use in the direct production of food and food ingredients or commodities which he sells, as provided by IC § 6-2.5-5-2(b). This is known as the "double direct test" for the agricultural exemption.

Taxpayer refers to two non-tax Indiana statutes, IC § 15-12-1-1 and IC § 15-12-1-10, to support its position that it is a "farmer" as defined by 45 IAC 2.2-5-1(a). After review, the Department of Revenue is not convinced that the two non-tax statutes support Taxpayer's position. Those statutes merely state that agricultural cooperatives may perform agricultural activities. They do not state that agricultural cooperatives are automatically considered to be performing agricultural activities. Therefore, whether or not a taxpayer qualifies for the agricultural exemption is dependent on its use of the tangible personal property at issue, as required by IC § 6-2.5-5-2(b).

Next, Taxpayer refers to Sales Tax Information Bulletin 9 (January 2016), which states:

When used by entities occupationally engaged in agricultural production, blending and loading equipment used for plant food and crop protection products is exempt because this item consists of various dedicated equipment that facilitates the moving of exempt items from temporary storage locations to the location where they will be used. This would include loaders, scales, conveyors, pumps, temporary tankage, and the associated plumbing.

Taxpayer believes that this provision supports its position that it qualifies for the agricultural exemption.

The Department refers to the Indiana Tax Court's decision in Merchandise Warehouse v. Indiana Dept. of State Revenue, 67 N.E.3d 666 (Ind. Tax 2017), in which the court provided:

Merchandise Warehouse's argument, however, ignores one salient point: both the Consumption and Equipment Exemptions employ a "double direct" standard. See I.C. §§ 6-2.5-5-3, -5.1. As this Court has previously explained, the minimum threshold requirement of the double direct standard is that the taxpayer who purchases the electricity or equipment in question must use those purchased items as part of its own process to produce other tangible personal property, "not as part of an alleged process of another taxpayer." See Indiana Waste Sys., 633 N.E.2d at 362-63. See also Interstate Warehousing, 783 N.E.2d at 252. Id. at 671-72. (Emphasis in original)(Emphasis added).

Therefore, any taxpayer claiming an exemption with a double direct standard, as required by the agricultural exemption found under IC § 6-2.5-5-2(b), must directly use the item(s) as part of its own process in order to qualify for the exemption. Taxpayer states that it applies fertilizer to its members' fields and that the members own the co-op, therefore Taxpayer is fertilizing its own fields. The Department does not agree with this position. The cooperative is a distinct entity from its members. The fertilizing of other entities' fields does not satisfy the double-direct test, as explained by the court in Merchandise Warehouse.

Also, Taxpayer states that it breeds and raises hogs through a wholly-owned subsidiary. In support of this position, Taxpayer provided the contract between the wholly-owned subsidiary and a non-related farm which raised the hogs. The Department does not agree that this arrangement constitutes Taxpayer's raising of hogs. Either the subsidiary or the third-party farm was using equipment in the hog-raising business. Taxpayer did not raise the hogs. Neither has Taxpayer established how it used any of the equipment deemed taxable in the instant audit in an exempt manner. Therefore, since Taxpayer was not directly using the items it purchased in the direct production of agricultural commodities as an essential and integral part of its own integrated process, Taxpayer is not eligible for the agricultural exemption under IC § 6-2.5-5-2, 45 IAC 2.2-5-1(a), and as reiterated by the court in Merchandise Warehouse.

Regarding Taxpayer's claim that it is eligible for the manufacturing exemption, Taxpayer states that it manufactured fertilizer which it then spread on its members' fields. Specifically, Taxpayer states that blending equipment was used to create a new marketable product. The Department determined in its audit that Taxpayer did not manufacture fertilizer, but rather purchased dry fertilizer which it either sold "as-is" or which it blended into a combination of fertilizers to customers' specifications.

Taxpayer and the Department view the blending activities differently. Taxpayer believes that the blending results in a new product, distinct from its component parts. Taxpayer emphasizes the importance of applying the correct amounts of different fertilizers to the customers' fields. The Department views the transaction as the purchase of component parts which Taxpayer subsequently blends as a convenience for its customers.

Of relevance is IC § 6-2.5-5-3(b), which provides:

> Except as provided in subsection (c), 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, including material handling equipment purchased for the purpose of transporting materials into such activities from an onsite location.

Also, the Indiana Supreme Court has provided guidance in what constitutes a "marketable product" in its decision in Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003), in which the Court stated:

> The Tax Court itself has identified the elements of "production of other tangible personal property" in a number of cases in recent years. The "distinct marketable good" requirement is illustrated by White River Envtl. P'ship v. Department of State Revenue, 694 N.E.2d 1248, 1252 (Ind. Tax Ct.1998). In that case, the taxpayer, an operator of a wastewater treatment facility, claimed the exemption at issue here for the sales and use taxes it paid on chemicals and materials consumed during its treatment process. The Tax Court correctly concluded that byproducts generated by the treatment process–clean water, ash and sludge–were not part of a production process "because the 'products' of [the taxpayer's] treatment process do not satisfy any market...." Id.
> Id. at 250.

In the instant case, Taxpayer states that it blends chemicals specifically for each field to which fertilizer is applied. Taxpayer uses a blender and other equipment to blend different fertilizers together prior to application. This, Taxpayer believes, constitutes the production of a distinct marketable good which, in turn, qualifies the blending equipment for the exemption provided by IC § 6-2.5-5-3(b).

After review of the materials supplied in the course of the protest process, the Department does not agree with Taxpayer's position. The Court in Interstate Warehousing also provided:

> Interstate argues that it is engaged in processing because it processes chilled ammonia to produce conditioned air and sells "the cooled, dehydrated and conditioned air that it processes." Pet'r's Mem., App. at 90. But we think the Department has the better part of the argument: "Interstate [does not] 'perform an integrated series of operations' resulting in a transformed end product to Interstate's customer.... The cool air merely maintains the customer's previously manufactured goods. There is no substantial change in 'form, composition, or character' to those goods. The cold air is only incidental to the service of storing previously manufactured goods." Mem. in Supp. of Resp. to Mot. For Summ. J. and Cross-Mot. For Summ. J., App. at 76. We hold that Interstate is not engaged in the "business of ... processing."
>
> Interstate Warehousing, at 252.

The Department acknowledges the importance of fertilizer in agriculture, but is not convinced that the documentation provided in the audit and protest processes establish that Taxpayer's customers are purchasing specific blends of fertilizer rather than component fertilizers. As the court in Interstate Warehousing explained, the cold air produced by that taxpayer was incidental to the service of storing other business' goods. Here, the documentation provided does nothing to rebut the Department's position that Taxpayer sells fertilizer and then blends it to customers' specifications. The blending is an incidental service provided to Taxpayer's customers who purchase more than one basic fertilizer. Taxpayer has not established that there was a substantial change in form, composition, or character to the fertilizer prior to purchase by its customers.

As an alternate position, Taxpayer has provided a description of its handling of liquid fertilizer. That description explained that a specific fertilizer is purchased at ratio of 32-0-0. This denotes the standard fertilizer ratios of nitrogen, phosphate, and potash. In order to drop the freezing point and to increase stability at lower temperatures, Taxpayer adds water to change the ratio to 28-0-0. This makes the fertilizer easier to be handled and stored at lower temperatures.

The Department is not convinced that this qualifies as a manufacturing process. As explained by the court in Interstate Warehousing, a substantial change in form, composition, or character of the tangible personal property is required to qualify as the production of other tangible personal property. Here, Taxpayer dilutes nitrogen fertilizer for ease of handling and storage at lower temperature. It is still nitrogen fertilizer. Taxpayer has not established that the dilution constitutes production of a new product.

In conclusion, Taxpayer has not met the burden imposed under IC § 6-8.1-5-1(c) of proving the proposed assessments wrong. Taxpayer did not use the items under protest in its own agricultural production process. Neither did Taxpayer manufacture fertilizer. Therefore, Taxpayer is eligible for neither the agricultural exemption nor the manufacturing exemption. Taxpayer also included in its protest two spreadsheets with listings of transactions it considered exempt for reasons unrelated to the two exemptions previously discussed. Taxpayer did not provide any explanation or documentation beyond listing these transactions on the spreadsheets. Taxpayer has not presented a sufficiently developed argument for the Department to address. See Wendt LLP v. Indiana Dept. of State Revenue, 977 N.E.2d 480, 485 n.9, (Ind. Tax Ct. 2012) (stating in a footnote parenthetical "that poorly developed and non-cogent arguments are subject to waiver" by the Indiana Tax Court) (citing Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138, 1145 (Ind. Tax. Ct. 2010)).

FINDING

Taxpayer's protest is denied.

III. Tax Administration–Penalties.

DISCUSSION

Taxpayer protests the imposition of penalties pursuant to IC § 6-8.1-10-2.1. Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> "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 standard for waiving the negligence penalty is given at 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. 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 protests the Department's assessment of penalties. Taxpayer states that its actions were reasonable and that even if it is not sustained on the protest of base tax, it should not be subject to penalty. After review of the documentation and analysis provided in the protest process, the Department does not agree with Taxpayer's position. Taxpayer was audited for prior years and substantially the same issues arose in this audit. Therefore, waiver of penalties is not warranted under 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest to the imposition of penalties is denied.

SUMMARY

Taxpayer's protest is denied regarding the imposition of sales tax in Issue I. Taxpayer's protest is denied regarding the imposition of use tax in Issue II. Taxpayer's protest is denied regarding the imposition of penalties in Issue III. Taxpayer's claim for refund of any tax or penalty is denied.

Posted: 05/31/2017 by Legislative Services Agency
An html version of this document.