

DEPARTMENT OF STATE REVENUE

04-20181293R.ODR

Final Order Denying Refund: 04-20181293R
Gross Retail Tax
For the years 2013 and 2014

NOTICE: IC § 4-22-7-7 permits the publication of this document in the Indiana Register. The publication of this document provides the general public with information about the Indiana Department of Revenue's official position concerning a specific set of facts and issues. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Final Order Denying Refund.

HOLDING

Prescription Drug Distributor was not entitled to a refund of sales tax paid on purchases of materials or equipment consumed or employed in distributing pharmaceuticals; Drug Distributor was not in the business of manufacturing the drugs, and the materials and equipment and supplies did not constitute "government furnished property" used to fulfill federal contracts.

ISSUES**I. Gross Retail Tax - Labels, Wrapping, and Shipping Materials.**

Authority: IC § 6-2.5-1-5; IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-2.5-3-1(a); IC § 6-2.5-3-2(a); IC § 6-2.5-5-9(d); IC § 6-2.5-5-9(d)(1); IC § 6-2.5-5-9(d)(2); *Rhoads v. Indiana Dep't of State Revenue*, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); *Indiana Dept. of State Rev. v. Kimball Int'l Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); [45 IAC 2.2-5-16](#); [45 IAC 2.2-5-16](#)(d)(1).

Taxpayer argues that it is entitled to a refund of sales tax it paid on the purchase of labels, printed patient instructions, and wrapping materials because it uses these items to ship pharmaceutical drugs to health insurance beneficiaries.

II. Gross Retail Tax - Manufacturing Exemption.

Authority: IC § 6-2.5-5-3(b); [45 IAC 2.2-5-8](#)(a); [45 IAC 2.2-5-8](#)(c); [45 IAC 2.2-5-8](#)(d); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974).

Taxpayer claims that it is entitled to a refund of sales tax it paid on the purchase of certain machinery and equipment on the ground that it uses these devices in preparing its drug shipments.

III. Gross Retail Tax - Federal Government Contracts.

Authority: IC § 6-2.5-5-24(a)(1); FAR Part 45.101(a); FAR Part 45.102; FAR Part 45-505-1(a); FAR Part 52.245; FAR Part 52.245(c)(2); FAR Part 52.245(c)(4); FAR Part 52.245(d); [45 IAC 2.2-3-14](#)(2)(A).

Taxpayer states - in the alternative - that it is entitled to a refund of sales tax paid on the purchase of labels, printed instructions, and wrapping materials on the ground that its contract with the federal government requires these items be used or included in the shipment of drugs paid for by the federal government.

STATEMENT OF FACTS

Taxpayer is an out-of-state entity which describes itself as a "pharmacy benefit management" company. Taxpayer operates an Indiana processing and distribution center. Taxpayer provides its fulfillment services to insurance companies, employers, workers' compensation plans, and government health programs.

Taxpayer contracts with insurance providers to provide the insurance beneficiaries "discounted medicines." Taxpayer contracts with retail pharmacies to allow insurance beneficiaries to obtain these drugs either directly from the pharmacies or through mail-orders placed with the pharmacies.

In 2016, Taxpayer submitted a sales tax refund claim with the Indiana Department of Revenue ("Department") arguing that it was entitled to claim numerous sales tax exemptions. The Department conducted an audit review

of Taxpayer's business and purchase records. An audit report was issued which concluded that Taxpayer was not entitled to any portion of the refund. Taxpayer protested but limited its protest to a portion of the originally claimed refund. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Final Order Denying Refund results.

I. Gross Retail Tax - Labels, Wrapping, and Shipping Materials.

DISCUSSION

Taxpayer purchased packing materials for bottling and shipping prescription drugs to individual insurance beneficiaries from a vendor called "Unisource." The packing materials include "packages, envelopes, cartons, gel packs, and coolers." Taxpayer explains that the gel packs and coolers are necessary to preserve temperature sensitive prescription drugs during shipment.

Taxpayer states that it is entitled to the exemption pursuant to IC § 6-2.5-5-9(d) which provides as follows:

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:

- (1) selling the contents that the person adds; or
- (2) shipping or delivering tangible personal property that:
 - (A) is owned by another person;
 - (B) is processed or serviced for the owner; and
 - (C) will be sold by that owner either in the same form or as a part of other tangible personal property produced by that owner in the owner's business of manufacturing, assembling, constructing, refining, or processing. See also [45 IAC 2.2-5-16](#).

The Department's audit report disagreed that Taxpayer was entitled to the refund explaining:

The Taxpayer has not supported the exemption claimed under [45 IAC 2.2-5-16](#) since it is not known how the items in question were used, who used the items, or if they were used in Indiana. Therefore the Taxpayer has not supported that the items are packaging materials that are used by the purchaser as enclosures or containers for selling contents to be added. (Emphasis in original).

The particular portion of the regulation, [45 IAC 2.2-5-16\(d\)\(1\)](#), cited and relied upon by the Department states:

(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.

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 *Rhoads v. Indiana Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

In general, all purchases of tangible personal property are taxable unless specifically exempted by statute. IC § 6-2.5-1-5. Nonetheless, Indiana provides various exemptions from sales tax and use tax under [IC 6-2.5-5](#) et seq. However, in applying any tax exemption, the overarching rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dept. of State Rev. v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). The Indiana Tax Court has held that, "[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." *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 101 (Ind. Ct. App. 1974).

Taxpayer's argument necessarily relies on the application of IC § 6-2.5-5-9(d) which exempts nonreturnable "wrapping materials and empty containers" Taxpayer does not fall under the first provision of the statute because it is not in the business of "selling the contents that the [purchaser] adds." IC § 6-2.5-5-9(d)(1). Although

Taxpayer ships or delivers prescription drugs which are "owned by another person" and provides shipping and servicing for these sellers, the "sellers" in this case are the pharmacies which are licensed to dispense the drugs. Taxpayer's argument fails because the pharmacies are not in the "business of manufacturing, assembling, constructing, refining, or processing" the drugs. IC § 6-2.5-5-9(d)(2). Bearing in mind Indiana's law which requires that exemptions be strictly and not liberally construed, the Department must decline the opportunity to expand the exemption beyond the four corners of the statute.

FINDING

Taxpayer's protest is respectfully denied.

II. Gross Retail Tax - Manufacturing Exemption.

DISCUSSION

Taxpayer sought a refund of sales tax it paid on the purchase of "machinery and equipment (including safety apparel and equipment, etc.), and their related and replacement parts . . ." on the ground that the items - such as printers, servers, and mail inserting equipment - are "directly used in [its] manufacturing process."

In support of its argument, Taxpayer cites to IC § 6-2.5-5-3(b) which provides:

[T]ransactions involving manufacturing machinery, tools, and equipment, including material handling equipment purchased for the purpose of transporting materials into activities described in this subsection from an onsite location, 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.

Taxpayer also cites to [45 IAC 2.2.5-8\(c\)](#) [*sic*, [45 IAC 2.2-5-8\(c\)](#)]:

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.

In particular, Taxpayer points to the example provided at [45 IAC 2.2-5-8\(d\)](#) which explains in part:

The production of *pharmaceutical items* is accomplished by a process which beings with weighing and measuring out appropriate ingredients, continues with combining and otherwise treating the ingredients, and ends with packaging the items. (*Emphasis added*).

The Department's audit report disagreed with Taxpayer's contention that it was entitled to claim Indiana's manufacturing exemption. The report explained that "Taxpayer is not in the business of manufacturing drugs" but "is an automated pharmaceutical processing facility and distribution center for prescription drugs."

Taxpayer disagrees with the audit report on the ground that its equipment - printers, mail inserters, servers, and the like - are exempt because the pharmaceuticals are "not marketable . . . until after they are sorted, weighed, inspected, packaged, and labelled with prescription information." Taxpayer admits that it acquires and then redistributes "bulk drugs" but explains that the operation of its Indiana facility "is the last integral, essential step to transform them into a marketable product" thereby rendering the equipment exempt from sales or use tax.

Taxpayer explains its process:

[Taxpayer] operates a home fill facility . . . in Indiana. The facility processes prescriptions for delivery to [insurance beneficiaries]. This process involves sorting, weighing, inspecting, packaging, and prescription labelling large volumes of prescription drugs into proper quantities. Containers are labelled with specific quantities, [beneficiary] names and dates, and usage and dosage instructions. The prescription drugs are assembled into the appropriate containers and packaging suitable for direct mail to [beneficiaries], including specialty medication that requires special handling. Prescription drugs are delivered to the end user in a specific quantity, and are also provided in a timely manner for ease of consumption. Facility machinery labels and packages prescription drugs for safe consumption and delivery.

Taxpayer concludes that it is a "manufacturer" of pharmaceuticals and that is machinery, servers, printers, mail inserting equipment, safety apparel, and related repair parts are exempt because they are "directly used in its manufacturing process."

The Department must respectfully disagree; [45 IAC 2.2-5-8\(a\)](#) emphasizes that the exemption is limited to that equipment "directly used by the purchaser in direct production." [45 IAC 2.2-5-8\(c\)](#) specifies that "directly used" means that the equipment has "an immediate effect on the article being produced." In this case, Taxpayer's printers, mail inserters, and printers do not have an "immediate effect" on the pharmaceuticals Taxpayer provides on behalf of the drug owners. Taxpayer ships the drugs after they have been sorted, packaged, and labeled but it does not produce the drugs, and the equipment for which it claims the exemption has no discernable effect on the drugs its customers purchase and acquire. Taxpayer is not in the business of producing drugs, and its "marketable product[s]" are the pharmaceuticals its customers purchase and expect to receive.

In addition, it is useful to point out that Taxpayer argues strenuously that it does not produce anything, does not sell pharmaceuticals, but that it is merely a "service provider" facilitating the delivery of drugs from pharmacies to individual insurance beneficiaries. Given that objection, it is difficult to reconcile Taxpayer's argument that it "directly produces" the drugs and that it is entitled to rely on the statutory exemption. Taxpayer is reminded - as pointed out above - that every exemption claim must fit squarely "within the exact letter of the law" *RCA Corp.*, 310 N.E.2d at 101. Taxpayer's claim fits neither squarely nor exactly within the exemption provision consistent with Taxpayer's assertion that it does not buy drugs and does not sell drugs.

FINDING

Taxpayer's protest is respectfully denied.

III. Gross Retail Tax - Federal Government Contracts.

DISCUSSION

Taxpayer makes a secondary, overlapping argument to the argument set out in Parts I and II above. Taxpayer explains that it provides pharmaceutical services on behalf of the federal government. Taxpayer provides these services to "military service members, retirees, and their dependents" under contract with the federal government. Taxpayer states that equipment and supplies acquired in fulfillment of its federal contracts becomes the property of the federal government.

[Taxpayer's] foundational [federal] contract mandates that title to all materials acquired by [Taxpayer] in performance of the contract transfers to the Federal Government ("title-vesting clause"). [Taxpayer's] subsequent contracts incorporated the [Federal Acquisition Regulations] through various clauses in those contracts.

As authority for its position, Taxpayer cites to FAR Part 52.245-2 ("Federal Acquisition Regulation") which provides in part:

The Government shall retain title to all Government-furnished property. All Government-furnished property and property acquired by the Contractor, title to which vests in the Government under this paragraph ("Government property") are subject to the provisions of this clause. However, special tooling accountable to this contract is subject to the provisions to the Special Tooling clause and is not subject to the provisions of this clause. Title to Government property shall not be affected by its incorporation into or attachment to any property not owned by the Government, nor shall Government property become a fixture or lose its identity as personal property by being attached to any real property. FAR Part 52.245(c)(2).

Taxpayer also cites to FAR Part 52.245-2(c)(2)-2 which explains:

If this contract contains a provision directing the Contractor to purchase material for which the Government will reimburse the Contractor as a direct item of cost under this contract -

- (i) Title to material purchased from a vendor shall pass to and vest in the Government upon the vendor's delivery of such material; and
- (ii) Title to all other material shall pass to and vest in the Government upon -
 - (A) Issuance of the material for use in contract performance;
 - (B) Commencement of processing of the material or its use in contract performance; or

(C) Reimbursement of the cost of the material by the Government, whichever comes first.

During the time during which it performed these fulfillment services, Taxpayer "allocated the costs of overhead materials used in performing health care administration services to the Federal Government." However, Taxpayer contends it erroneously "paid and/or accrued tax on purchases of tangible personal property where tax was not due."

In the first instance, Taxpayer states that it "purchased machinery and equipment (including safety apparel and equipment, etc.) and their related repair and replacement parts, along with services performed on the machinery" For example, Taxpayer explains that it purchased a printer which was used twenty-five percent of the time to print labels on drugs supplied to beneficiaries pursuant to its contract with the federal government. Under Taxpayer's argument, an "allocated portion" of the cost of equipment used to fulfill its obligations under the federal contract is exempt from sales tax and that it is now entitled to a refund of an "allocated portion" of the sales tax it paid on that equipment. "Allocated" or not, Taxpayer states that much of this equipment and none of the supplies would have been purchased if Taxpayer did not provide its services to and for the federal government.

Taxpayer buttresses its argument by citing to the Department's regulation, [45 IAC 2.2-3-14\(2\)\(A\)](#), which states that Indiana's "use tax does not apply to the following":

Gross income derived from sales to the United States government, but only to the extent to which the state of Indiana is prohibited from taxing such gross income by the constitution of the United States. *See also* IC § 6-2.5-5-24(a)(1) (exempting the United States government from Indiana's sales tax).

Taxpayer summarizes stating that because title to the equipment and supplies vests with and is transferred to the federal government and because the cost of that equipment was allocated and billed pursuant to a federal contract, its "indirect overhead purchases qualified as exempt sales for resale."

In part, the federal regulations on which Taxpayer relies also state that federal contractors "are ordinarily required to furnish all property necessary to perform Government contracts." FAR Part 45.102. The regulation further distinguishes "contractor-acquired property" which is "provided by the contractor for performing a contract and to which the government has title" and "Government-furnished property" which is "directly acquired by the Government and subsequently made available to the Contractor." FAR Part 45.101-1(a). In addition, the regulation requires that "government-furnished" property "be used only for performing [the federal] contract" FAR Part 52.245(d).

The rules regarding "government-furnished property" are detailed and stringent. A contractor - such as Taxpayer - is required to maintain "basic information" on government-furnished property including each item's "name, description and National Stock number," the "quantity," "unit price," contract number," "code designation," "location" and ultimate "disposition" of each item of government-furnished property. FAR Part 45-505-1(a).

The Federal Acquisition Rules on which Taxpayer relies makes a clear distinction between "government purchased" supplies - which are billed to the federal government as direct items of cost" - and "contractor-acquired property" - which is "ordinarily required by the contractor" as "necessary to perform Government contracts." In Taxpayer's case, there is nothing to support Taxpayer's contention that the items of property at issue were billed to the government as "direct costs" or were acquired or furnished by the federal government itself. Taxpayer's own argument, that it allocated equipment and supply costs based upon the extent to which it uses the items to fulfill federal contracts, would seem to fly in the face of the rule that federally supplied equipment "be used only for performing [the federal] contract" FAR Part 52.245-2(d).

The Department concludes that the items of equipment which form the basis of Taxpayer's claim - printers, safety apparel, labels - represent routine costs and expenses "ordinarily required" in fulfillment of its federal contracts for which there is no readily apparent Indiana sales tax exemption.

In addition Taxpayer argues that it is entitled to a refund of sales tax on a portion of its electric utility costs. That argument is easily disposed of because there is no indication that the federal government furnished or was billed for the electricity just as there is no indication that the federal government eventually took title to the electricity. Just as with printers, equipment, and labels, utilities are not the "government-furnished property" and do not represent "direct costs" attributable to Taxpayer's federal contracts.

The Department is unable to agree with Taxpayer that it is entitled to a refund of sales tax on the allocated and indirect overhead expenses of unsegregated equipment, supplies, materials, and utilities consumed in the

ordinary course of Taxpayer's service-based business.

FINDING

Taxpayer's protest is respectfully denied.

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An [html](#) version of this document.