

DEPARTMENT OF STATE REVENUE

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**Letters of Findings Numbers:
04-20191237, 04-20191238, 04-20191239
Sales and Use Tax
For Tax Year 2015-2017**

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 This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Related manufacturing companies demonstrated that (1) some, but not all, of their capital assets qualified for the manufacturing exemption as packaging for a marketable product, (2) tax had already been paid on several transactions assessed in the audit, and (3) the Department erred in assessing the incorrect use percentage to a forklift. The companies failed to meet their burden on their other claims due to insufficient documentation.

ISSUES

I. Use Tax–Manufacturing Exemption.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-5-3; IC § 6-2.5-5-4; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; *Merch. Warehouse Co. v. Indiana Dep't of State Revenue*, 87 N.E.3d 12 (Ind. 2017); *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); *Tri-States Double Cola Bottling Co. v. Dep't of State Revenue*, 706 N.E.2d 282 (Ind. Tax Ct. 1999); *Mysnberge v. Indiana Dep't of State Revenue*, 716 N.E.2d 629 (Ind. Tax Ct. 1999); *Indiana Dep't of State Revenue 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 2.2-3-4](#); [45 IAC 2.2-5-8](#).

Taxpayers claim eligibility for the manufacturing exemption.

II. Sales and Use Tax–Documentation.

Authority: IC § 6-8.1-5-1; IC § 6-8.1-5-4.

Taxpayers provide documentation not initially provided during the Department's audit.

STATEMENT OF FACTS

Taxpayers manufacture and sell cardboard boxes as packaging materials. As the result of an audit for the tax years 2015, 2016, and 2017, the Indiana Department of Revenue ("Department") determined that Taxpayers had not paid sales tax or use tax on certain taxable purchases. The Department therefore issued proposed assessments for sales tax, use tax, penalty, and interest. Taxpayers protested the proposed assessments, claiming that Taxpayers qualified for exemptions from tax which they did not receive and new documentation shows Taxpayers already paid taxes on several transactions at issue in this case. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Use Tax–Manufacturing Exemption.

DISCUSSION

Taxpayers argue that the Department failed to apply two different exemptions in the course of its use tax calculations. First, Taxpayers claim that the audit incorrectly taxed an exempt payment for an employee's residential rent. Reviewing the pull list of purchases in the audit report shows that no tax was assessed on that

rent payment, and thus Taxpayers' argument on this exemption is moot. Second, and more substantially, Taxpayers disagree with the audit's application of the manufacturing exemption.

As a threshold issue, it is a 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 under 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.

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 exempted by a statute. [45 IAC 2.2-5-8\(a\)](#). 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* (1877), 58 Ind. 130, 133). 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). The exemptions sought by Taxpayers are, like all tax exemption provisions, 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. Indiana Dep't of State Revenue*, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999).

Taxpayers argue that the manufacturing exemption applies to several purchases that the audit found to be taxable. Taxpayers argue that the transactions under protest involve tangible personal property that is either directly used or consumed in the manufacturing process. The relevant statute is IC § 6-2.5-5-4, which, for the tax years at issue, states in part:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for his direct use in the direct production of the machinery, tools, or equipment described in section 2 or 3 of this chapter.

In addition, the version of IC § 6-2.5-5-3(b) for the relevant tax years provides:

[T]ransactions 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.

Finally, 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. . . .

Taxpayers disagree with the audit's application of the manufacturing exemption. Taxpayers argue that (1) the purchase of multiple capital assets qualified for the manufacturing exemption, 2) several miscellaneous transactions qualified for the manufacturing exemption, and 3) the audit incorrectly stated the taxable percentage use for a forklift transaction partially used in manufacturing. These issues will be addressed in turn.

1. Capital Assets

Taxpayers protest the assessment of additional tax on capital expenditures for machinery used to package Taxpayers' boxes for shipping. The audit found that this was a post-production process and did not qualify for the manufacturing exemption.

[45 IAC 2.2-5-8\(c\)](#) explains in more detail the requirements for the manufacturing exemption:

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*. (Emphasis added).

"[T]he production process does not conclude when it yields a potentially marketable product, but when it yields the most marketable good--'the product actually marketed.'" *Merch. Warehouse Co. v. Indiana Dep't of State Revenue*, 87 N.E.3d 12, 18 (Ind. 2017)(quoting *Aztec Partners, LLC v. Indiana Dep't of State Revenue*, 35 N.E.3d 320, 325 (Ind. Tax Ct. 2015)). The Department's regulation [45 IAC 2.2-5-8\(d\)](#) specifically references packaging as part of that "actually marketed" product:

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. (Emphasis added).

Taxpayers explained at the hearing that their product was not individual cardboard boxes, but packs of multiple boxes organized to meet customer size requirements. To support this claim, Taxpayers provided an invoice for a return where their boxes were not accepted by a customer because the packaging did not meet the customer requirements. Based on this information, the equipment used to create these final products, i.e. bundles of boxes, would be exempt from tax, while equipment that merely prepared these products for shipping would not be exempt.

Taxpayers explained at the hearing the purpose of each of the capital assets that were in protest. They broke the assets down into 5 categories: stackers, strappers, banders, wrappers, and conveyors. Stackers organize and stack boxes for bundling. Strappers wrap these stacked boxes into bundles, the size of which is determined by Taxpayers' customers. Conveyors then carry these bundles to a banding station, where the bundles are attached to a pallet and shrink wrapped for transport. Based on the facts presented at the hearing, Taxpayers are not marketing individual boxes, but organized and bundled sets of boxes. However, the evidence presented at the hearing failed to demonstrate that the marketable product is actually a wrapped pallet of boxes as opposed to bundles of stacked boxes. Therefore, Taxpayers met their burden and showed that the assets pertaining to stackers and strappers are exempt from tax, but failed to meet their burden regarding the conveyors, the banders, and the wrappers. The Department grants Taxpayers' protest on the stackers and strappers and denies it on the remaining equipment.

2. Miscellaneous Purchases

Taxpayers provided multiple spreadsheets containing a variety of transactions which they claim qualify for the manufacturing exemption. Taxpayers only provided one sentence of detail, at most, explaining why these items are exempt. For several of the claimed items, Taxpayers could not identify how or where that specific item was

used. Based on the descriptions of these items, it appears that Taxpayers claimed the items were exempt because they were used to repair machinery, they were safety items, or they were consumed in the production process.

"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 transactions that appear to involve the repair or maintenance of equipment are therefore taxable. The Department denies Taxpayers' protest on these items.

Safety clothing or equipment is exempt from tax when it is "*required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.*" [45 IAC 2.2-5-8\(c\)\(2\)\(F\)](#)(*emphasis added*). Claimed equipment, such as gloves, was ostensibly for safety, but Taxpayers did not explain how those items were *required* for participation in production, which is necessitated by the language of the regulation. The Department denies Taxpayers' protest on these items.

The remaining claims involve items that Taxpayers believe were directly used in the direct production of their product. Like the safety equipment and repairs, these transactions were not sufficiently described by documentation provided by Taxpayers. The information provided on these items was limited to a single sentence on a spreadsheet, which, without any further exhibits, images, or explanations, is simply insufficient to demonstrate that the given expense was used directly in Taxpayers' direct production process. The Department denies Taxpayers' protest on these items.

3. Forklifts

Taxpayers claim that the Department applied an incorrect use percentage when determining the taxable use of the rental of forklifts (also referred to as forktrucks). Taxpayers point out a transaction where the audit uses the wrong vendor name and fails to apply the agreed taxable percentage to the transaction.

[45 IAC 2.2-5-8\(f\)](#) provides generally that forklifts moving work-in-process are exempt:

Transportation equipment.

- (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.

--EXAMPLES--

...

- (3) A forklift is used exclusively to move work-in-process from a temporary storage area in a plant and to transport it to a production machine for processing. Because the forklift functions as an integral part of the integrated system comprising the production operations, it is exempt.
- (4) A forklift is used exclusively to move finished goods from a storage warehouse and to load them on trucks for shipment to customers. The forklift is taxable because it is used outside the integrated production process.
- (5) A forklift is regularly used 40 [percent] of the time for the purpose described in Example (3) and 60 [percent] of the time for the purpose described in Example (4). The taxpayer is entitled to an exemption equal to 40 [percent] of the gross retail income attributable to the transaction in which the forklift was purchased. (*Emphasis added*).

Upon review of the purchase pull list, the protested fork truck rental transaction (page 64 of the audit report) was

remarkably similar to other fork truck rentals with a different listed vendor name (page 68 of audit report). All of these rentals appeared to use the same, eleven character invoice numbering and were for identical dollar amount. Taxpayers have sufficiently shown that these transactions should have been identified as from the same vendor. The protest on this issue is granted and the Department will apply the same exemption percentage to each of these transactions.

FINDING

Taxpayers' protest is granted regarding the stackers, strappers, and the forklifts, and denied in the remainder.

II. Sales and Use Tax—Documentation.

DISCUSSION

In their protest, Taxpayers also claim that several transactions were incorrectly used by the audit as a basis for proposed assessments. Taxpayers claim that they have already paid use tax on these transactions and that the transactions assessed sales tax were exempted but the exemption certificates were not reviewed.

IC § 6-8.1-5-4(a) requires taxpayers keep records to support their own tax calculations, stating:

Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. *The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks.*
(Emphasis added).

Therefore, taxpayers must keep books and records such as, but not limited to, invoices, register tapes, receipts, and cancelled checks, as provided by IC § 6-8.1-5-4(a). If the Department reasonably believes that a person has not reported the proper amount of tax due, the Department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the Department, as provided by IC § 6-8.1-5-1(b). In the instant case, the Department reviewed the records provided during the audit and sampling, then used the best information available to reach the conclusion that Taxpayers failed to remit sales tax or pay use taxes on several taxable transactions.

Taxpayers claim that the Department's sales tax sampling incorrectly included a transaction that was exempt in Stratum 3 and that the correct taxable amount of that Stratum should be \$0. Taxpayers note that the exemption certificate for Ohio was provided to the auditor by mistake, which is why the transaction was erroneously included as taxable. An AD-70 and ST-105 were provided, showing that the transaction in question was exempt from tax in Indiana. Taxpayers have met their burden of proof on this issue. The sampling will be corrected and Taxpayers' liability will be recalculated.

Taxpayers also provided several invoices which were missing during the original audit. These documents show that Taxpayers already paid use tax on many of the transactions the Department used to assess use tax in the audit. However, Taxpayers also protested transactions for which they did not provide corresponding invoices or documentation. The most notable example, specifically identified in Taxpayers' protest filing, asks the Department to infer payment of use tax on a transaction where no records have been provided. Even assuming that the Department could infer the payment of use tax from other invoices on similar transactions, the Department will not make an inference about a transaction it does not have evidence actually occurred. To the extent invoices were provided which show that Taxpayers had paid use tax which was not credited in the audit, Taxpayers' protest is granted subject to audit verification.

FINDING

Taxpayers' protest is partially granted subject to audit verification.

SUMMARY

Taxpayers' protest is sustained in Issue I above regarding stackers, strappers, and forklifts and denied in all other regards. Taxpayer's protest is sustained in Issue II above regarding transactions for which new documentation was provided at the hearing, and denied in all other regards.

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