**DEPARTMENT OF STATE REVENUE**
**LETTER OF FINDINGS NUMBER: 04-0213**
**Gross Retail & Use Tax-Production Exemption**
**Penalty-Request for Waiver**
**For Tax Year 2000**

NOTICE: Under Ind. Code § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

## ISSUES

**I. Gross Retail and Use Taxes—Production exemption**

**Authority:** IC § 6-8.1-5-1(b); IC § 6-2.5-2-1; IC § 6-2.5-3-6; IC § 6-2.5-3-7; IC § 6-2.5-5-5-3(b); IC § 6-2.5-5-5.1; 45 IAC 15-5-3(8); 45 IAC 2.2-2-1; 45 IAC 2.2-3-4; 45 IAC 2.2-5-8

Taxpayer protests the assessment of use tax on two items used in taxpayer's automobile manufacturing business where no gross retail tax was paid at the point of purchase. Taxpayer claims the materials are exempt from tax because they are part of the production process.

**II. Penalty—Request for waiver**

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

Taxpayer protests the imposition of the 10% negligence penalty and requests a waiver.

## STATEMENT OF FACTS

Taxpayer manufactures automobiles. During the tax year at issue, taxpayer failed to self-assess and remit use tax on purchases where no gross retail tax was paid at the point of purchase. Taxpayer is protesting the proposed assessment of use tax on two items: a "device" employees use to aid in installing back seats in vehicles without causing back injuries, and a paint purge thinner used to clean spray nozzles in the robotic arms that spray paint on vehicles. Additional facts will be supplied as necessary.

**I. Gross Retail and Use Tax—Production exemption**

## DISCUSSION

Taxpayer protests the assessment of use tax on two specific items taxpayer uses in manufacturing automobiles. The first one, the "device," was developed by taxpayer's engineers as a result of employees incurring back injuries during the installation of back seats into the vehicles. The second one, the paint purge thinner system, cleans different colors of paint from robotic arm paint sprayer nozzles in between color paint applications for clear and clean paint applications. Taxpayer submitted two videotapes documenting the back seat installation and the paint application systems, plus a document attesting to the lack of injuries that followed the use of the "device" to install back seats.

The audit stated that taxpayer purchased seat turntables to use in removing car seats purchased from an outside vendor from the upper and lower levels of storage racks. The audit considered the seats to be raw materials. Taxpayer also purchased parts of lifters, which are used as the parts are removed from the "table" which, according to the audit, constitutes storage of raw materials. The audit also stated that taxpayer purchased paint purge chemicals and paint line chemicals without paying gross retail tax. The audit characterized these purchases as being used in maintenance, not production. The audit stated that the paint thinner is not mixed with the paint to be sprayed, but is used after one color stops and before the next color starts. "Production is halted for that particular piece of equipment while it is cleaned. Cleaning machinery is considered machine maintenance and not exempt. . .." A prior Letter of Findings denied taxpayer on this same issue.

Taxpayer stated in its protest that it had been working on measures to reduce injuries at the rear seat assembly process in the "trim and final" section of automobile production. Workers had sustained back injuries caused by the repetitive and awkward motion of lifting bulky and heavy (35 pounds) seats and installing them into vehicles. Taxpayer's engineers and workers developed a design for a "device" to help prevent such back injuries. This "device" holds several racks of rear seat assemblies at one time. Workers push buttons and the "device" automatically lifts and positions the rear seat to where the worker can install it into the vehicle without lifting the seats or moving his body into awkward and potentially injurious positions.

Taxpayer also purchased an air-powered lifter/scissor and powered turntable to install in the "device" that allows workers to lift the rear seat assemblies for installation. Taxpayer argues that the "device" is clearly not used for storage, but is an integral part of its production process. Taxpayer also states that use of the "device" has virtually eliminated the kinds of injuries workers were incurring before the "device" was developed. Taxpayer specifically cites 45 IAC 2.2-5-8(c)(2)(F) to support its contention that the "device" is an essential and integral part" of its back seat installation process: "Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production."

With respect to the paint purge thinner, taxpayer stated in its protest that it has a "very sophisticated and complex painting system which is fully automated." According to taxpayer, the process involves applying three coats of paint to each vehicle. The last coat (top coat) is sprayed onto each vehicle by use of automatic paint robots, which are pre-programmed to make

their arms perform various painting tasks based on vehicle type and model. They are also pre-programmed to match a specific topcoat color to each vehicle.

Taxpayer's typical production run consists of painting 400-600 vehicles per shift. Throughout each shift, the robots change colors as required, on average, every 9.5 vehicles. Each color change during the painting process takes three seconds and requires flashing paint thinner on the inside and tip of the robotic arms to purge the existing color paint. Taxpayer argues that without the use of the paint thinner, the old or existing paint color would mix with the new color paint, resulting in an unacceptable quality of paint on the vehicle and therefore resulting in an unmarketable product.

Taxpayer argues further that the painting process requires the paint robots to continuously apply rotating colors of paint to various types of vehicles on a moving conveyor. Taxpayer argues that the color changing process is an essential and integral part of the taxpayer's painting system, and use of the paint thinner is an essential and integral part of the color changing process.

Pursuant to IC § 6-8.1-5-1(b) and 45 IAC 15-5-3(8), a "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 assessment is made." Pursuant to IC § 6-2.5-2-1, a "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." *See also*, 45 IAC 2.2-2-1. Pursuant to IC §§ 6-2.5-3-1 through 6-2.5-3-7, 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." An exemption is provided in IC § 6-2.5-3-4 if "the property was acquired in a retail transaction and the state gross retail tax" was paid at the time of purchase. Taxpayers are personally liable for the tax. (IC § 6-2.5-3-6). IC § 6-2.5-3-7 provides that a "person who acquires tangible personal property from a retail merchant for delivery in Indiana is presumed to have acquired the property for storage, use, or consumption in Indiana;" therefore, the presumption of taxability exists until rebutted. *See also*, 45 IAC 2.2-3-4.

The specific statute at issue, IC § 6-2.5-5-5.1, provides in pertinent part:

> 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.

The specific regulation at issue, 45 IAC 2.2-5-8, provides in pertinent part:

> (a) In 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. The exemption provided in this regulation extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.

(b) 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.

(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.

(d) 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.

The general rule, outlined in great detail in the regulation, is that purchases are either subject to the state's gross retail tax or the state's use tax unless the specific exemption applies. The parameters of the so-called "production exemption" are narrow: to be exempt, the tangible personal property must be directly used in the direct production of other tangible personal property. The regulation defines direct use and direct production as requiring "an immediate effect on the article being produced;" i.e., the production-exempt tangible personal property must be an essential and integral part of an integrated process."

Taxpayer's arguments with respect to the "device" are well taken. The document and videotape show that the "device" has enabled employees to install the back seats without injury. The audit characterizes the "device" as storage of raw materials. It appears that storage is ancillary to the "device's" function as providing a safe means by which taxpayer installs back seats into its vehicles while at the same time ensuring employee safety. Taxpayer's protest of this part of the assessment is sustained.

The Department has reviewed the videotape of the painting process, the prior Letter of Findings denying taxpayer on this issue, and all relevant statutes and regulations. A well-painted car is a marketable product. A badly painted car is not. The paint purge thinner is required to ensure

that every vehicle is properly painted. However, that does not make the paint purge thinner part of production. Cleaning products are not part of a production process, no matter how important they are to the quality of the finished product. Taxpayer's protest of this part of the assessment is denied.

## FINDING

Taxpayer's protest concerning the assessment of use tax on items taxpayer alleged fell within the production exemption to the state's gross retail and use taxes is sustained as to the "device," and denied as to the paint purge thinner.

**II. Penalty—Request for waiver**

## DISCUSSION

Taxpayer protests the imposition of the 10% negligence penalty on the assessment.

Indiana Code Section 6-8.1-10-2.1(d) states that if a taxpayer subject to the negligence penalty imposed under this section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit taxes held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty. Indiana Administrative Code, Title 45, Rule 15, section 11-2 defines negligence as the failure to use reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by Indiana's tax statutes and administrative regulations.

In order for the Department to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of tax due was due to reasonable cause. Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying or failing to carry out a duty giving rise to the penalty imposed. . . ." In determining whether reasonable cause existed, the Department may consider the nature of the tax involved, previous judicial precedents, previous department instructions, and previous audits.

Taxpayer has not set forth a basis whereby the Department could conclude taxpayer exercised the degree of care statutorily imposed upon an ordinarily reasonable taxpayer. Therefore, given the totality of all the circumstances, waiver of the 10% negligence penalty is not appropriate in this particular instance.

## FINDING

Taxpayer's protest concerning the proposed assessment of the 10% negligence penalty is denied