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DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 04-970135
Sales and Use Tax
For The Period: 1994 and 1995

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ISSUES

I. Sales/Use Tax: Exemption for Manufacturing Machinery

Authority: IC 6-2.5-5-3; 45 IAC 2.2-5-8(k)

The taxpayer protests the assessment of sales/use tax.

II. Tax Administration: Penalty

Authority: IC 6-8.1-10-2.1

The taxpayer protests the assessment of a negligence penalty.

STATEMENT OF FACTS

The taxpayer receives fireworks in bulk from various vendors outside of the United States. When the taxpayer receives the fireworks the taxpayer must repackage the fireworks—since they are in an inappropriate package. The taxpayer cannot use the original import packaging, and instead must use a UN corrugated box. In addition to repackaging, the taxpayer rearranges the packages—creating different assortments of fireworks for resale. Each assortment of fireworks requires printing and laminating of labels on the products, and corrugated sheets, die-cut, folded, filled with product, shrink wrapped and boxed. This process requires the use of conveyors, shrink wrap machines, and other machinery. The taxpayer has trademarks on some of its products as well.

I. Sales/Use Tax: Exemption for Manufacturing Machinery

DISCUSSION

The touchstone for analyzing the taxpayer's protest is Indiana Code 6-2.5-5-3 which states, "transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring the property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property." Elaborating on this, the Indiana Administrative Code states:

> Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property is a performance as a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change, and it must result in a transformation of property in a different product having a distinctive name, character, and use. Operations such as compounding, fabricating, or assembling are illustrative of the types of operations which may qualify under this definition.

See 45 IAC 2.2-5-8(k). The taxpayer asserts that it is processing and assembling fireworks into marketable firework assortments. The taxpayer contends that this is a production process. If, *arguendo*, the taxpayer is a manufacturer for these purposes, then its use of machinery to produce such products would be exempt from Indiana's sales/use tax. To buttress its argument, taxpayer relies on a triad of cases: Cave Stone, Harlan Sprague Dawley, and Mid-America. The courts in these cases have viewed production expansively: "In the context of industrial exemptions, 'production' is viewed expansively as 'all activity directed to increasing the number of scarce economic goods'." Harlan Sprague Dawley, 605 N.E.2d at 1228 (quoting Cave Stone, 457 N.E.2d at 524. Also of import is Mid-America Energy Resources, 681 N.E.2d at 262 where the court focused on the creation of a marketable good).

The central issue presented by the taxpayer's protest is whether or not the taxpayer is a manufacturer—that is, making a product. The Department is following the Tax Court's lead in examining whether a product is made. For instance, the Tax Court in Mechanics Laundry & Supply, Inc. v. Indiana Dept. of State Revenue, 650 N.E.2d 1223 (Ind. Tax Ct. 1994) held that the laundering of soiled textiles merely "perpetuate[d] textiles that were produced by *others*." Id. at 1230 (Emphasis added). Since the taxpayer in Mechanics Laundry did not produce new tangible personal property, the court found that it was not entitled to the industrial exemptions.

In a letter to the Department, dated May 27, 1997, the taxpayer states:

> Much like tomatoes which can be diced, sliced, crushed or pureed they are still tomatoes. Fireworks can be repackaged and be a different item.

It is appropriate that the taxpayer uses tomatoes as an analogy, given that the Indiana Tax Court

has recently addressed the issue of tomatoes. In Indianapolis Fruit Co., v. Indiana Dept. of State Revenue, Cause No. 49T10-9702-SC-00129 (Ind. Tax Ct. 1998), the Tax Court held that the ripening and packaging of tomatoes was not production, and thus not exempt. The Tax Court focused on the fact that that Indianapolis Fruit, the taxpayer in the case, did not induce the tomato ripening process. The Tax Court characterized the tomato ripening and repackaging process thusly:

> [O]nce they arrive, they inspected for color, firmness, temperature damage, and over all quality. They are then placed in tomato processing units, which are controlled for temperature, humidity, and air circulation. When the tomatoes are adequately ripened, they are either shipped in bulk or further processed by Indianapolis Fruit.
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> The further processing of some tomatoes is required because some of Indianapolis Fruit's customers order tomatoes packaged by size and ripeness. Indianapolis Fruit washes and dries these tomatoes. They are then sorted by size and ripeness, packaged in styrofoam trays and wrapped in plastic.

Id. at 3, 4. In examining the taxpayer's claim, the court stated that to give Indianapolis Fruit "the exemption for its tomato ripening equipment would allow…[it]…to reap where it has not sown." Id. at 12. The court distinguished this from Indianapolis Fruit's banana ripening process, where the taxpayer actively brought about the ripening and expedited it by the use of gases. Without the active impact on the fruit-via gases introduced to expedite ripening,--the court found no production. The court held that "tomato packaging does not constitute production" and that the tomato packaging did not change the "form, composition, or character" of the tomatoes. Id. at 13. Again, as the court put it:

> Because there is no production preceding the tomato packaging, the packaging is not an integral and essential part of an integrated production process.

Id. at 13. Even within the framework of an expanded definition of production, the taxpayer comes closer to falling within the rubric of Indianapolis Fruit (and for that matter Mechanics Laundry) than it does Cave Stone, Harlan Sprague Dawley, and Mid-America. The taxpayer admits, in a letter dated February 21, 1997, that it does not "manufacture the individual fireworks." The taxpayer does not act upon the fireworks themselves (that is, the taxpayer does not manufacture fireworks), and therefore does not qualify for production exemptions for its packaging of assortments of fireworks. As the Tax Court noted with regard to tomatoes, Indianapolis Fruit "sorted" and packaged the tomatoes into "styrofoam trays" but since the taxpayer did not produce the tomatoes themselves (or act directly and actively upon them, as Indianapolis Fruit did with its bananas), then no exemption was available. The same is applicable for the case at hand.

To recapitulate: the taxpayer receives a finished product (fireworks) from sources outside of the United States, repackages and rearranges (assortments) those fireworks. In Indianapolis Fruit the

taxpayer in that case received a product (which ripened on its own while in Indianapolis Fruit's possession), repackaged and sorted the tomatoes. In the latter case this was not production, and the Department finds the same for the former.

FINDING

The taxpayer's protest is denied.

II. Tax Administration: Penalty

DISCUSSION

The taxpayer protests the imposition of the ten percent (10%) negligence penalty. The negligence penalty subjects a taxpayer to a ten percent penalty if the taxpayer incurs a deficiency that is due to negligence. *See* IC 6-8.1-10-2.1. The taxpayer bears the burden of proving that the deficiency was not due to negligence, but was due to reasonable cause. The taxpayer in its protest focuses on the amounts in question, stating "Our company spends several million dollars on goods and services. The amounts to be found taxable in your audits are small by comparison." *See* 5/27/97 Letter. The inference that the taxpayer wants the Department to make is that the numbers, and not the nature of the items, should be focused on in making its determination. However it is germane to examine some of the items at issue, which are non-controversial in being taxable: (1) subscriptions to periodicals; (2) the rental of tangible personal property; (3) building repair materials, (4) computer equipment; (5) office supplies; (6) videos; and (7) auto repair parts.

FINDING

The taxpayer's protest is denied.