DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 06-0141
Sales and Use Tax
Tax Period 2001-2003

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ISSUES

I. Sales and Use Tax-Manufacturing Exemption

Authority: IC § 6-8.1-5-1(b); IC § 6-8.1-5-4; IC § 6-2.5-3-2(a); IC § 6-2.5-5-3; 45 IAC 2.2-5-8(h)(1); *Gross Income Tax Division v. National Bank and Trust Co.,* 79 N.E.2d 651 (Ind. 1948); *Rotation Products v. Department of State Revenue*, 690 N.E.2d 795 (Ind. Tax 1998)

The taxpayer protested the assessment of use tax on certain items which it alleges qualified for the manufacturing exemption.

II. Tax Administration - Ten Percent Negligence Penalty

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

The taxpayer protested the imposition of the ten percent negligence penalty.

III. Tax Administration - Interest

Authority: IC § 6-8.1-10-1(e).

The taxpayer protests the imposition of interest.

STATEMENT OF FACTS

The taxpayer is an industrial processor of re-treaded tires. After an audit, the Indiana Department of Revenue (department) assessed additional sales tax, use tax, interest, and penalty. The taxpayer protested a portion of this assessment. A hearing was held and this Letter of Findings results.

I. Sales and Use Tax - Manufacturing Exemptions

DISCUSSION

The department assessed tax on the taxpayer's use of rim repair equipment, paint, tire analyzing equipment and supplies, shot blasting tools and supplies, cleaning equipment, gloves, and markers. The department assessed use tax on these items because they were used for maintenance rather than directly in the direct production of tangible personal property. The taxpayer protested this assessment and disallowance of the claim for refund as it related to the use tax assessed on these items.

Notices of proposed assessments are prima facie evidence that the department's claim for unpaid taxes is valid**.** IC § 6-8.1-5-1(b). The taxpayer has the burden of proving that the department incorrectly imposed the assessment. Id. Taxpayers are required to keep adequate books and records so that the department can determine the proper tax owed to the state. IC § 6-8.1-5-4.

Indiana imposes an excise tax on tangible personal property stored, used, or consumed in Indiana. IC § 6-2.5-3-2(a). A number of exemptions are available from use tax, including those collectively referred to as the manufacturing exemptions. IC § 6-2.5-5-3 provides for the exemption of "manufacturing machinery, tools and equipment which is to be directly used by the purchaser in the direct production, manufacture, fabrication... of tangible personal property."

The application of the directly used in direct production exemption to items used in maintenance functions is clarified at 45 IAC 2.2-5-8(h)(1) as follows:

> 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.

All exemptions must be strictly construed against the party claiming the exemption. *Gross Income Tax Division v. National Bank and Trust Co.,* 79 N.E.2d 651 (Ind. 1948).

The taxpayer contends that the protested items qualify for the directly used in direct manufacturing exemption because its process is actually the remanufacturing of tire rims.

The taxpayer cites *Rotation Products v. Department of State Revenue*, 690 N.E.2d 795 (Ind. Tax 1998) in support of its contention that the items on which use tax was assessed qualify for the manufacturing exemption as directly used in direct production. In that case, Rotation Products took worn out and useless ball bearings and performed several complicated processes on them and processed them into usable ball bearings which were comparable to new ball bearings. The court found that this was actually a production process and materials directly used in the direct production of the reworked ball bearings qualified for a manufacturing exemption from the use tax. The taxpayer contends that the process on the tire rims is so precise and extensive that it constitutes processing rather than mere maintenance.

In deciding the *Rotation Products*case, the court found that the extensive work done to the ball bearings changed them from a useless item to a new and marketable product, a ball bearing. The taxpayer's case does not

meet that standard. Rather it is more like the repeated dry cleaning of items which allows the items to be reused within their normal life cycle which the court cited as a taxable form of maintenance. Customers take their wheels to the taxpayer. After performing the maintenance on the wheel, the taxpayer returns the wheel to the customer. The taxpayer did not sustain its burden of proving that the assessed items were used in a process producing entirely new marketable products. Rather, the taxpayer's work on tire rims merely perpetuates the useful life of the tire rims. Therefore the process is a maintenance function. As such the materials used in that maintenance function do not qualify for the exemption.

FINDING

The taxpayer's protest is denied.

II. Tax Administration - Ten Percent Negligence Penalty

DISCUSSION

The taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 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:
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> (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.
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> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The taxpayer provided substantial documentation to indicate that its failure to pay the assessed use tax was due to reasonable cause rather than negligence.

FINDING

The taxpayer's protest is sustained.

III. Tax Administration- Interest

DISCUSSION

The taxpayer also protested the imposition of interest on the assessment. The department does not have the authority to waive the interest statutorily imposed on tax assessments. IC § 6-8.1-10-1(e).

FINDING

The taxpayer's protest is denied.

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