

Letter of Findings Number: 07-0007
Sales and Use Tax
For Tax Years 2003-05

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ISSUES

I. Sales and Use Tax—Imposition

Authority: IC § 6-2.5-3-2; IC § 6-2.5-4-2; IC § 6-8.1-5-1; [45 IAC 2.2-5-10](#)

Taxpayer protests the assessment of use tax on a variety of purchases.

II. Tax Administration—Negligence Penalty

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#)

Taxpayer protests the imposition of a ten percent negligence penalty.

III. Tax Administration—Interest

Authority: IC § 6-8.1-10-1

Taxpayer protests the imposition of interest.

STATEMENT OF FACTS

Taxpayer provides outside testing services to manufacturers in Indiana. After an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed use tax and assessed a negligence penalty for the tax years 2003, 2004, and 2005. The Department found that Taxpayer had made a variety of purchases on which the Indiana sales tax was not paid at the time of purchase nor was use tax remitted to the Department. Taxpayer protests the imposition of tax, penalty, and interest on these purchases.

I. Sales and Use Tax—Imposition

DISCUSSION

All tax assessments are presumed to be accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC § 6-8.1-5-1(b).

The Department found that use tax was due on purchases that Taxpayer had made without paying sales tax on them. Indiana imposes "an excise tax, known as the use tax," on tangible personal property that is acquired in retail transactions and is stored, used, or consumed in Indiana. IC § 6-2.5-3-2(a). Taxpayer maintains that because it performs testing services on its customers' manufactured product it is an "industrial processor," which is allowed an exemption from sales and use tax on machinery, tools, and equipment used in direct production under [45 IAC 2.2-5-10](#).

Pursuant to [45 IAC 2.2-5-10\(a\)](#) "[i]n general, all purchases of tangible personal property by persons engaged in the processing or refining of tangible personal property are taxable." However, it allows for an exemption from sales and use tax for "manufacturing machinery, tools, and equipment used in direct production." Property that is acquired for "use in direct production" is defined in [45 IAC 2.2-5-10\(c\)](#) as the "manufacturing machinery, tools, and equipment to be directly used by the purchaser in processing or refining" and that has "an immediate effect on the article being produced." Property has "an immediate effect" when it becomes "an essential and integral part of the integrated process which produces tangible personal property." [45 IAC 2.2-5-10\(c\)](#). This exemption is extended to "industrial processors, as defined in [IC 6-2.5-4-2](#)." [45 IAC 2.2-5-10\(a\)](#).

As [45 IAC 2.2-5-10\(a\)](#), in relevant part, instructs:

[A]n industrial processor, as defined in [IC 6-2.5-4-2](#), is one who:

- (1) acquires tangible personal property owned by another person;
- (2) provides industrial processing or servicing, including enameling or plating, on the property; and
- (3) transfers the property back to the owner to be sold by that owner either in the same form or as a part of other tangible personal property produced by that owner in his business of manufacturing, assembling, constructing, refining, or processing.

Processing or refining is defined in [45 IAC 2.2-5-10\(k\)](#), as follows:

Processing or refining is defined as the performance by a business of an integrated series of operations which places tangible personal property in a form, composition, or character different than that in which it was acquired. The change in form, composition, or character must be a substantial change. Operations such as distilling, brewing, pasteurizing, electroplating, galvanizing, anodizing, impregnating, cooking, heat treating, and slaughtering of animals for meal or meal products are illustrative of the types of operations which constitute processing or refining, although any operation which has such a result may be processing or refining. A processed or refined end product, however, must be substantially different from the component materials used.

Accordingly, an industrial processor is a business that receives property that is owned by another, puts the

property through an integrated series of operations which cause a substantial change in the form, composition, or character of the property, and returns it to the owner to be sold in this newly created form, composition, or character.

Taxpayer receives products from its customers, and performs tests that assess the durability of the products and tried to see if Taxpayer can make the products fail. Then Taxpayer returns the products to the customers either in the same condition as they were received if they pass the tests or in a damaged condition if the products fail the tests. Products that fail the tests are returned to the customers to be corrected, stripped of parts, recycled, or disposed of in any manner the owner desires. Taxpayer asserts that a substantial change takes place to the tested products because upon the failure of testing, the products are "changed" in that more durable parts are used, or a program is rewritten to improve or change the performance of the product. However, these changes referenced by Taxpayer are not made by Taxpayer. In fact, these changes are made by Taxpayer's customers once the failed products are given back to its customers. Since Taxpayer does not cause a substantial change in the form, composition, or character of the property, Taxpayer does not provide processing or refining services as required under IC § 6-2.5-4-2(c)(2). Moreover, since the failed products are returned to the customers in an unmarketable condition, the products are not being transferred back to the customer for sale as is required under IC § 6-2.5-4-2(c)(3). Therefore, Taxpayer does not meet the requirements of an industrial processor and is nothing more than a service provider that is subject to sales and use tax on all of its purchases.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration–Negligence Penalty

DISCUSSION

Taxpayer protests the imposition of the ten percent negligence penalty for the tax years in question. The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides, "if a person... incurs, upon examination by the department, a deficiency that is due to negligence... the person is subject to a penalty."

[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.

In this case, Taxpayer incurred a deficiency which the Department determined was due to negligence under [45 IAC 15-11-2](#)(b), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). Taxpayer has not affirmatively established that its failure to pay the remaining deficiencies was due to reasonable cause and not due to negligence, as required by [45 IAC 15-11-2](#)(c).

FINDING

Taxpayer's protest to the imposition of penalty is respectfully denied.

III. Tax Administration–Interest

DISCUSSION

The Department added interest on the tax liabilities assessed pursuant to the audit. Taxpayer protests this imposition of interest. The Department refers to IC § 6-8.1-10-1(a) which provides, as follows:

If a person fails to file a return for any of the listed taxes, fails to pay the full amount of tax shown on the person's return by the due date for the return or the payment, or incurs a deficiency upon a determination by the department, the person is subject to interest on the nonpayment.

The Department does not have the authority to waive the interest pursuant to IC § 6-8.1-10-1(e).

FINDING

Taxpayer's protest to the imposition of interest is respectfully denied.

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