

Letter of Findings: 07-0331
Sales and Use Tax
For December 28, 2004, Purchase

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ISSUES

I. Sales and Use Tax – Manufacturing Exemption.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-5-3; IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-12](#); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the imposition of use tax on a wheel loader it uses in its processing operation.

II. Tax Administration – Imposition of Negligence Penalty.

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

The Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an out-of-state S corporation that primarily crushes concrete, but also asphalt, brick and other materials acquired from demolition and excavation contractors in order to produce aggregate materials. Taxpayer has a processing plant in Indiana.

Materials are brought into Taxpayer's plant by private companies who deliver it as scrap, as an alternative to hauling it to a landfill. At other times Taxpayer's own crews pick up the materials at the contractors' jobsites. Taxpayer charges a tipping fee to dump used materials. The material is stockpiled on Taxpayer's premises. The raw material stockpile contains concrete, asphalt, brick, and related materials from building and road demolitions and can be in any size or shape. Concrete containing rebar is accepted. At some point the stockpile is moved to a crusher, where it is crushed and processed into aggregate materials.

While still in the stockpile, Taxpayer uses an excavator to scrape smaller amounts of material, such as dirt, off the stockpile. For pieces too large to eventually fit into the crusher, the excavator is set up with an attachment that "munches" the larger pieces into smaller ones. Also, the pieces that contain rebar are "munched" in order to remove the rebar. Once the material has been downsized and excess rebar has been removed, it, along with the other material that did not require "munching," is ready to be moved to the crusher.

Taxpayer utilizes a wheel loader to pick up the material and deliver it directly to the crusher, where it is loaded into the crusher's feeder. The crusher not only crushes the stone, but separates the material, through a series of screens, into various aggregates; i.e., various sizes of stone, sand, top soil, fill dirt, etc.

As a result of an investigation, the Indiana Department of Revenue ("Department") determined that Taxpayer had purchased a wheel loader without paying sales tax at the time of purchase. Accordingly, the Department issued a proposed assessment for use tax, negligence penalty and interest on January 29, 2007. On May 5, 2007, Taxpayer protested the imposition of the use tax assessment associated with the purchase of this loader. An administrative hearing was held and this Letter of Findings results. Additional facts will be provided as necessary.

I. Sales and Use Tax – Manufacturing Exemption.

DISCUSSION

When it purchased the wheel loader, Taxpayer provided the seller an ST-105 (Indiana Department of Revenue Sales Tax Exemption Certificate) marked "Direct Production" as the exemption type. On initial review, the Department found that Taxpayer had purchased a piece of equipment without properly paying sales tax at the time of purchase and assessed use tax on the purchase.

Taxpayer protests the imposition of use tax on the purchase of the wheel loader. Taxpayer states that the loader is used in its processing operation and so should be exempt from sales and use tax.

All tax assessments are prima facie evidence that the Department's claim for the tax is valid; and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

IC § 6-2.5-2-1 provides:

- (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.

IC § 6-2.5-3-2(a) provides:

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.

Accordingly, Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq. An exemption from the use tax is granted for transactions where the gross retail tax ("sales tax") was paid at the time of purchase pursuant to IC § 6-2.5-3-4.

Taxpayer contends that Taxpayer's use of the equipment qualified for an exemption, therefore, Taxpayer did not pay the sales or use tax at the time of purchase. Taxpayer asserts that the Taxpayer's purchase of the equipment meets the direct production exemption.

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. IC § 6-2.5-5-3(b); [45 IAC 2.2-5-8\(a\)](#). The exemption only applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. *Id.* Machinery, tools, and equipment are directly used in the production process if they have an immediate effect on the article being produced. [45 IAC 2.2-5-8\(c\)](#). A machine, tool, or equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. [45 IAC 2.2-5-8\(c\)](#). An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." [45 IAC 2.2-5-8\(c\)](#), example 1.

[45 IAC 2.2-5-8\(k\)](#) describes direct production as the performance of an integrated series of operations which transforms the matter into a form, composition or character different from that in which it was acquired, and that the change must be *substantial* resulting in a transformation of the property into a different and distinct product.

The exemption for direct use in production is further explained at [45 IAC 2.2-5-12](#) as follows:

(a) The state gross retail tax shall not apply to sales of tangible personal property to be directly used by the purchaser in the direct production or manufacture of any manufacturing or agricultural machinery, tools, and equipment described in [IC 6-2.5-5-2](#) or [6-2.5-5-3](#) [[IC 6-2.5-5-3](#)].

(b) The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to tangible personal property directly used in the direct production of manufacturing or agricultural machinery, tools, and equipment to be used by such manufacturer or producer.

(c) The state gross retail tax shall not apply to purchases of tangible personal property to be directly used by the purchaser in the production or manufacturing process of any manufacturing or agricultural machinery, tools, or equipment, provided that the machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect upon the article being produced or manufactured. The 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) For the application of the rules [subsections] above, refer to Regs. 6-2.5-5-3 [[45 IAC 2.2-5-8](#) through [45 IAC 2.2-5-10](#)] with respect to tangible personal property used directly in the following activities: pre-production and post-production activities; storage; transportation; tangible personal property which has an immediate effect upon the article produced; maintenance and replacement; testing and inspection; and managerial, sales, and other nonoperational activities.

(e) Energy equipment.

(1) Equipment used to modify energy purchased from public utilities for the production process is exempt if the equipment.

(2) Equipment used to create energy that could otherwise be purchased exempt from a public utility for use by exempt equipment is exempt.

(3) When any equipment qualifies as essential and integral to the production process and also is used in an alternative nonessential and/or non-integrated manner, the exemption shall only apply to the percentage of use of the equipment used in the exempt manner.

[45 IAC 2.2-5-8\(d\)](#) states:

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.

Here, the issue is whether Taxpayer's production process begins before the materials are introduced to the crusher, thus exempting the loader that transports the materials to the crusher.

[45 IAC 2.2-5-8\(c\)](#), example 1, describes a process of manufacturing aluminum pistons. It states, in relevant part, that the manufacturing process begins *after* the removal of the raw aluminum from storage, with the melting of the raw aluminum and the production of castings in the foundry. *Id.*

[45 IAC 2.2-5-8\(c\)](#), example 4, illustrates types of equipment in Example 1 that are not exempt because of a "lack of an essential and integral relationship with the integrated production system." Among the types of non-exempt equipment, Part (G) of example 4 lists "equipment used to remove raw materials from storage prior to introduction into the production process."

However, [45 IAC 2.2-5-8\(f\)](#), which describes the exemption status of transportation equipment used in the manufacturing process, states that transportation equipment used to transport "work-in-process" from storage is

not subject to tax if the transportation is within the production process. [45 IAC 2.2-5-8\(f\)\(3\)](#).

As example 5 of [45 IAC 2.2-5-8\(f\)](#) illustrates, a piece of transportation equipment may be used for both exempt and non-exempt purposes in the manufacturing process. A taxpayer is entitled to an exemption equal to the percentage of exempt use of the equipment.

The fact that a machine is essential to the conduct of the business of manufacturing by practical necessity does not itself mean that the machine is essential and integral to the direct production of the final product. [45 IAC 2.2-5-8\(g\)](#).

Initially, the Department determined that processing does not begin until the material is introduced into the crusher, because prior to that time the material had not been substantially changed.

Taxpayer, in its May 5, 2007, letter of protest argues that the Department's investigation missed a step in its processing operations. Taxpayer stated that the "raw material are down sized by a jaw crusher or ram hoe before being moved to the wheel loader." Taxpayer attached a copy of [45 IAC 2.2-5-8](#) to its protest letter and placed a check mark next to the language of [45 IAC 2.2-5-8\(f\)](#), example 2, presumably to argue that its loader should be exempt just as the transportation equipment is exempt in the example. [45 IAC 2.2-5-8\(f\)](#), example 2, illustrates the following:

A metal and alloy [*sic*] manufacturer pulverizes raw materials for use in an exempt furnace. Weigh bins are utilized for the temporary storage of the exempt materials after pulverization and prior to use in an exempt furnace. Transportation equipment used to transport the pulverized raw material to and from the weigh bins is exempt.

The Taxpayer, therefore, argues that its stockpile is substantially changed prior to transport to the, presumably, exempt crusher.

On a follow-up visit by the Department's investigator to Taxpayer's premises, Taxpayer agreed that at times contractors bring in loads that do not require preparation before the loader loads the materials to take to the crusher. The Department concluded after spending time observing Taxpayer's operation, that the primary function of the excavator was to "scrape the debris off of the hard pile mound so the loader could get to it to scoop it up." The Department observed that numerous loads of debris had not been changed by the excavator at all. The Department agreed that some production begins prior to the use of the loader. The Department concluded that the use of the loader should be pro-rated since some of the loads come into the plant with nothing more done to them prior to crushing. [45 IAC 2.2-5-8\(f\)](#). The Department discussed these different scenarios with Taxpayer and asked Taxpayer what percent of use it thought should be taxable. Taxpayer continued to insist that the loader was one-hundred percent exempt. The Department's investigator then concluded that if one considered the volume of the stockpile and separated it between material small enough to go directly to the crusher, and the larger pieces of concrete that either had to be downsized and/or have rebar removed, and separated them into two piles, the ratio would be approximately 50/50. The Department's investigator observed that stockpile was similarly constituted on both occasions he had visited Taxpayer's premises.

The Department observed, and Taxpayer agreed, that some of the materials in the stockpile are not acted upon prior to transport to the crusher. In these instances, the loader is clearly taxable since it is merely moving materials to the crusher where the first step in processing begins.

Taxpayer, however, has also demonstrated that some of the materials in its stockpile are acted upon by machinery that begin transforming the materials before the loader picks them up and transports them to the crusher. In these instances, the loader is clearly exempt since the materials are now "work-in-process."

The Department's investigator determined that the ratio of exempt to non-exempt use of the wheel loader was 50/50. Since this Letter of Findings agrees that the wheel loader is used in both an exempt and a non-exempt manner, it then relies on the Department's ratio. Taxpayer has not met its burden of proof to demonstrate that the wheel loader is fully exempt, nor did it present any information that would allocate partial exempt use of the wheel loader.

FINDING

Taxpayer is sustained in part and denied in part, in that the wheel loader is determined to be fifty-percent exempt.

II. Tax Administration – Imposition of Negligence Penalty.

DISCUSSION

The Taxpayer also protested 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:

- (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.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer has not affirmatively established that its failure to pay sales tax on the purchase of the wheel loader was due to reasonable cause and not due to negligence, as required by [45 IAC 15-11-2\(c\)](#).

FINDING

Taxpayer's protest is respectfully denied. However, to the extent that Taxpayer is sustained on Issue I, Taxpayer's penalty will be reduced to ten-percent of the recomputed use tax.

CONCLUSION

Taxpayer will be assessed use tax on fifty-percent of the purchase price of the wheel loader.

Taxpayer's ten-percent penalty will be calculated based on fifty-percent of the purchase price of the wheel loader.

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