

Letter of Findings: 07-0529
Sales and Use Tax
For the Years 2004, 2005, 2006

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ISSUES

I. Use Tax – Manufacturing Exemption.

Authority: IC § 6-2.5-1-1 et seq.; 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); *Indiana Dep't of Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. Sup. Ct. 1983).

Taxpayer protests the imposition of use tax on funnel bins it claims are used in its integrated production process.

II. Tax Administration – Imposition of Negligence Penalty.

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

Taxpayer protests the assessment of negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana manufacturer of concrete masonry units and distributor of building materials.

Taxpayer is a registered retail merchant.

The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer for the years 2004, 2005, and 2006. Due to the nature and volume of Taxpayer's records, Taxpayer and the Department agreed to a methodology to project audit results. As a result of the audit, Taxpayer was assessed additional sales and use tax. Taxpayer agreed with all but one of the audit adjustments. Taxpayer duly protested the assessment of use tax on its use of certain funnel bins (not the silos) in its production process. A hearing was held and this Letter of Findings ensues. Additional facts will be provided as necessary.

I. Use Tax – Manufacturing Exemption.

DISCUSSION

The Department assessed use tax on bins it deemed were pre-production items and therefore not eligible for the sales and use tax manufacturing exemption.

Taxpayer protested the assessment of use tax on the bins which it claimed were used during its integrated production process.

All tax assessments are prima facie evidence that the Department's claim for the tax is valid; 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).

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.

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.

An exemption from 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.

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\(a\)](#). An exemption 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 piece of 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.

Finally, [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.

In a memo dated March 14, 2008, the Department's auditor describes Taxpayer's production process as follows:

Taxpayer's basic facility operation consists of raw materials (Haydite, sand, limestone, limestone dust, fly, ash, and cement) being delivered via vendor's trucks up a constructed ramp to dump their product into specific storage silos/bins. The raw materials are (gravity) fed into the production process from the funnel shaped silos/bins onto a conveyor that transports measured amounts of each material to the mixing tank. From the mixing tank, the blocks are then "formed" into specific shapes via tremendous pressure being applied to a "mold" of a particular design. The formed blocks are then moved to a curing oven for 24 hours, before being moved to "the yard" as inventory.

The Department found that the bins hold raw materials *prior* to their introduction into the production process. The Department contends that no action is taken on the raw materials after they are unloaded from the dump trucks into the bins. There is no processing, weighing, or measuring of raw materials in the bins. The Department contends that the first step in Taxpayer's production process begins with the measurement of raw materials at the time the materials are released by means of a door at the bottom from the bins onto the conveyor that moves it to the mixing tank. The Department allowed the manufacturing exemption on everything after the doors.

Therefore, the issue is whether Taxpayer's production process begins with the introduction of the raw materials into the bins, thus exempting the bins from sales and use tax, or at release from the bins when the raw materials are measured and gravity-fed onto the conveyor. Taxpayer argues that the introduction of the raw material into the bins where the material is funneled towards the trap door that measures the material in the first step in its integrated, automated production process.

Taxpayer describes its process in its September 24, 2007, letter of protest as follows:

In 2004 we replaced an antiquated material handling system with a new integrated system that is controlled electronically from the time raw materials are received in large funnel type bins until the manufacturing process is complete. The raw materials mix is determined by the product being manufactured and distributed from each funnel type bin and the cement silo is controlled automatically inside the plant. Our bins are not storage bins. In fact, raw material must be hauled in continuously during production. Basically, the only storage is enough material to start production each morning.

At hearing, Taxpayer described its relatively new, completely automated manufacturing plant which produces 8,000 to 10,000 blocks per day with only two people operating the plant. Taxpayer stated that it stores very little

raw material on its premises as part of its "just in time" production operation. Taxpayer has a cement silo on the premises which stores cement for several days, but the silos are not the subject of this protest. Other than cement, raw material is trucked onto the premises regularly throughout the day where the trucks dump raw material into the four funnel-type bins to start the production process. Each bin holds seventy-five tons, or three truckloads, of material.

After the hearing, Taxpayer provided a diagram of its plant and step by step descriptions of its manufacturing process, along with photographs documenting the manufacturing process. The first three steps described related to the bins in question. Taxpayer states:

1. Raw materials (sand, fill stone, A G lime dust and haydite) are delivered by truck and dumped into funnel bins. At this point automation takes over and human hands are not directly involved in the manufacturing process until the packaging (cuber) area. Our bins are not storage bins as raw materials must be delivered continually during the manufacturing process. Using the "just in time" concept, our goal is to only have enough material in the funnel bins at the close of each day to begin manufacturing the next morning. The funnel bins are part of the integrated plant doctrine as the entire plant including the funnel bins are controlled automatically and must be in sync with the entire manufacturing process.
2. Each raw material is automatically disbursed from the funnel bins in the correct amount based on the product being manufactured and at the correct time which is controlled automatically by the overall plant control system.
3. Raw materials are moved from the funnel bins by a belt conveyor to the mixer where cement and water are added.

Taxpayer cites to [45 IAC 2.2-5-8](#) exemption for temporary storage "necessary for moving materials being manufactured from one production step to another." Taxpayer argues that its position is further supported by the "integrated plant doctrine" in *Indiana Dep't of Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983). Taxpayer attached a CCH Internet Tax Research NetWork (practitioner comment) text that states that under the *Cave Stone* "integrated plant" doctrine, "property may be exempt if it is part of an integrated production process even if it does not come into direct contact with the work in process. [...]. Equipment and materials are exempt if used as an integral and essential part of an integrated production process."

[45 IAC 2.2-5-8\(e\)](#) states in part that storage equipment used for the purpose of storing raw materials or finishing goods are taxable. Temporary storage referred to under (1) is tangible personal property used in or for the purpose of storing work-in-process.

Taxpayer's reference to temporary storage in support of its contention is irrelevant as Taxpayer is not claiming that the production process began prior to the introduction of the raw materials into the funnel bins thus rendering the bins temporary storage.

"Direct production" is the performance of an integrated series of operations which transform the matter into the marketable article. [45 IAC 2.2-5-8\(k\)](#). For the bins to be "directly used" in Taxpayer's "direct production" process they must have an immediate effect on the article being produced. [45 IAC 2.2-5-8\(c\)](#). For the bins to have an "immediate effect" on the article being produced, the bins must be an essential and integral part of an integrated process that produces the article. [45 IAC 2.2-5-8\(c\)](#) Example 1.

Example 1 under [45 IAC 2.2-5-8\(d\)](#) states:

The production of pharmaceutical items is accomplished by a process which begins with weighing and measuring out appropriate ingredients, continues with combining and otherwise treating the ingredients, and ends with packaging the items. Equipment used to transport raw materials to the manufacturing plant is employed prior to the first operation or activity constituting part of the integrated production process and is taxable. Weighing and measuring equipment and all equipment used as an essential and integral part of the subsequent manufacturing steps, through packaging, qualify for exemption. Equipment which loads packaged products from the packaging step of production into storage, or from storage into delivery vehicles, is subject to tax.

In this case, it has been established that the bins do not function as storage bins. The bins function as devices to funnel and measure raw material as part of Taxpayer's production process. In the example cited above "weighing and measuring equipment" was considered to be part of the first step in production. Taxpayer has described an integrated, automated production process that depends on precise measurement of various combinations of raw materials. These raw materials are funneled by the separate bins through the bottom doors of the bins which are computer controlled to measure precise amounts of each different kind of raw material. As they are measured the raw materials are gravity released onto a conveyor belt where the measured materials are mixed.

At hearing Taxpayer stated that the physical integrity and durability of its products are dependent on several factors in its production process including the proper proportioning of various combinations of raw materials. The Department's audit report states that it allowed Taxpayer exemption of everything after the door, presumably because each bin's bottom door is automated to control measurement of the raw material being funneled through the bin. But the measurement, as illustrated in the example cited above, is the beginning of the integrated production process. The measuring devices in this instance are the funnel bins the bottom doors of which

measure the raw materials used to produce Taxpayer's marketable products.

Taxpayer has established that the funnel bins as described above are part of the first step in its production process and, therefore, are exempt from use tax because they are directly used in Taxpayer's direct production process.

FINDING

Taxpayer's protest is sustained.

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 affirmatively established, as required by [45 IAC 15-11-2](#)(c), its actions were due to reasonable cause and not due to negligence.

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer's protest is sustained both on the base tax and the negligence penalty.

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