

Letter of Findings: 08-0577
Sales and Use Tax
For the Year 2005, 2006, and 2007

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ISSUES

I. Sales and 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 § 6-2.5-5-5.1; IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-11](#); Rotation Products Corp. v. Indiana Dep't of State Revenue, 690 N.E. 2d 795 (Ind. Tax Ct. 1998); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the assessment of tax on purchases of tangible personal property.

II. Sales and Use Tax – Calculation.

Authority: Agreement for Projecting Audit Results.

Taxpayer also protests the calculation used to determine the Taxpayer's liability.

III. Tax Administration – Penalty.

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

Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer, located in Indiana, is a company that tests and recertifies used gas cylinders for its customers pursuant to federal regulatory requirements. In 2008, the Department of Revenue (the "Department") conducted a sales and use tax audit of Taxpayer. Pursuant to the audit, Taxpayer and the Department agreed to a methodology to project audit results. The audit resulted in an additional assessment of sales and use tax. Taxpayer protests the Department's assessment. A hearing was held. The Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Manufacturing Exemption.

DISCUSSION

The Department assessed additional use tax on items purchased for testing and recertifying the cylinders. Taxpayer stated that its process of testing and recertification constitutes remanufacturing cylinders and, therefore, pursuant to Indiana Code and case law, manufacturing exemptions apply to it.

All tax assessments are prima facie evidence that the Department's claim for the unpaid 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](#) provides:

- (a) 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, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable. [45 IAC 2.2-5-8\(a\)](#).

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. Additionally, in certain circumstances, exemptions from sales and use tax are available. [IC 6-2.5-5-3\(b\)](#) states that "transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property."

[IC 6-2.5-5-5.1\(b\)](#) provides that, in part,

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining,

repairing, mining, agriculture, horticulture, floriculture, or arboriculture.

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. *Id.* 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. (Emphasis added).

The exemption for direct use in production is further explained at [45 IAC 2.2-5-11](#), in part, 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.

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.

As stated above, taxpayer bears the burden of proof to overcome the Department's assessment. *Rotation Products Corp. v. Indiana Dep't of State Revenue*, 690 N.E.2d 795 (Ind. Tax Ct. 1998), which also involved a taxpayer that claimed the equipment and consumption manufacturing exemptions, stated that "exemptions are strictly construed against the taxpayer." *Id.* at 798. Thus, the taxpayer in *Rotation Products* bore the burden to demonstrate its eligibility for the exemptions. "After all, it is the taxpayer who knows his business, and it is the taxpayer who seeks the exemption." *Id.* Here, like the taxpayer in *Rotation Products*, Taxpayer claims that its testing and recertification of used cylinders constitutes remanufacturing of the cylinders and, therefore, it is eligible for the equipment exemption under IC § 6-2.5-5-3 and consumption exemption under IC § 6-2.5-5-1.1. Taxpayer thus bears the burden to show its eligibility for the exemptions under *Rotation Products*.

According to *Rotation Products*, a taxpayer is eligible for a remanufacturing exemption based on "whether the activity was directly involved in the creation of a product." *Rotation Products*, 690 N.E.2d at 799. To accomplish this goal, the *Rotation Products*' court established a four-part test, as follows:

- 1) The substantiality and complexity of the work done on the existing article and the physical changes to the existing article, including the addition of new parts;
- 2) A comparison of the article's value before and after the work;
- 3) How favorably the performance of the remanufactured article compares with the performance of newly manufactured articles of its kind; and
- 4) Whether the work performed was contemplated as a normal part of the life cycle of the existing article.

Id. at 802-03. Therefore, here, Taxpayer must satisfy all of the above to be considered a remanufacturer of cylinders.

A cylinder includes a tank which holds gas, a neck ring, and a valve. Taxpayer presented documentation that illustrated its multi-steps process of testing and recertifying gas cylinders. Those steps are (1) visual inspection of cylinders upon the cylinders' arrival; (2) detaching neck rings from the cylinder tanks; (3) Hydrostatic or Ultrasonic Evaluation testing (Test) of cylinders which involves placing the cylinders into a large vessel with water which is pressurized by a computer-operating machine (notably, Hydrostatic testing requires removal of the valves, but Ultrasonic Evaluation testing does not require removal of the valves); (4) refurbishing or replacing valves (re-valving) if need be; (5) sandblasting cylinders to remove old paint and re-smooth the surface; (6) painting

cylinders; (7) engraving the U.S. Department Of Transportation's marks of recertification onto the cylinders; (8) loading and shipping the cylinders back to Taxpayer's customers, who are the owners of the cylinders. Taxpayer does not add any gases to the cylinders.

Occasionally, Taxpayer's customers use the same cylinders, after they are recertified, to contain different types of gases from what the cylinders contained before they were shipped to Taxpayer. Those cylinders may require Taxpayer to change the valves or other components of the valve to comport with changed pressure requirements due to the use of a different gas. Those cylinders then undergo the same process of testing pursuant to federal regulatory requirements.

As stated above, Taxpayer must satisfy all of the four prongs of Rotation Products test to be considered a remanufacturer of cylinders. First, under Rotation Products, Taxpayer must demonstrate the substantiality and complexity of the work done on the existing article and the physical changes to the existing article, including the addition of new parts. Taxpayer has demonstrated that its process of testing cylinders is complex. However, Taxpayer's work does not significantly change the cylinders. Taxpayer first sorts through those cylinders upon their arrival of Taxpayer's facility. When cylinders still contain gases, Taxpayer returns those cylinders to their owners without doing anything even though their certifications are expired. Also, Taxpayer does not test cylinders when the cylinders are found to be damaged during Taxpayer's visual inspection. Additionally, if cylinders fail the Test, Taxpayer informs owners of the cylinders' failure. Taxpayer then sells those failed cylinders along with those damaged ones as scrap metal. Taxpayer does not repair those damaged and failed cylinders.

For cylinders that have passed the Test, Taxpayer then re-valves the cylinders, which may include refurbishing the original valves or replacing with new valves if valves were damaged. The cylinders are designed to allow for these periodic changes. Taxpayer then continues the same process of recertification. Taxpayer argues that replacing the valves of cylinders substantially changes cylinders because those cylinders can then be legally used for another 5 or 10 years. However, cylinders that undergo the Ultrasonic Evaluation testing do not require removal of valves. Taxpayer's Brief, at 4-5. Moreover, Taxpayer refurbishes or replaces the valves only after the cylinders have passed the Test. Documentation shows that Taxpayer does not manufacture any valves. Rather, Taxpayer purchases different standard sizes of valves as its inventory and replaces valves of cylinders if necessary. Taxpayer argues that replacing valves and/or components of valves prolongs the duration of the cylinders' useful life. But, Taxpayer does not pursue those steps if the cylinders are damaged or fail the Test. Unlike the repaired roller bearings in Rotation Products, Taxpayer does not repair the cylinders. Taxpayer scraps those damaged or failed cylinders and sells them as scrapped metal. Furthermore, based on its customers' preferences, Taxpayer then paints those cylinders which have passed the Test and been recertified. To ensure the new paint stays with the cylinders after recertification, Taxpayer utilizes sandblasting technique to clean the old paint on the cylinders. Although the cylinders look like-new because of new paint, repainting the cylinders does not rise to the level of a substantial change to the cylinders. In short, replacing neck rings, valves and components of valves, and painting are part of the maintenance of the cylinders. When cylinders are damaged or fail the Test, Taxpayer does not repair the cylinders or perform any of the steps of recertification mentioned above. Taxpayer failed to show the substantiality and complexity of the work done on the existing cylinders and the physical changes to the existing cylinders.

The fourth prong of Rotation Products looks at whether the work performed was contemplated as a normal part of the life cycle of the existing article. The court in Rotation Products examined the functionality of the roller bearings. The Rotation Products' court noted that as the roller bearings perform, the inner and outer rings inside the roller bearings undergo friction. As a result, the roller bearings, at some point, cease to function because of wear and tear. The Rotation Products' court found that there is no expectation attached to the purchases of roller bearings that the roller bearings could be reused again and again.

Here, the Taxpayer claimed that the used cylinders it refurbishes are legally unusable upon their arrival because their certifications have expired. Taxpayer argued that the life of a cylinder is 5 or 10 years, i.e., the duration of certification or recertification. Without recertification, a cylinder is unusable. However, unlike the roller bearings in Rotation Products, here, a cylinder, made out of metal, is not subject to friction when it performs. The federal mandates dictate the duration of a cylinder's certification depending on the intended use of cylinders. The federal regulations also control the requirements of cylinders' certification and recertification. The owner of a cylinder could reasonably expect that the cylinder it has purchased could be reused again and again as long as the cylinder is recertified periodically under the federal regulations. Taxpayer's documentation also shows that some of the cylinders which passed the Test and were recertified were manufactured in 1940s. When cylinders fail the Test, the cylinders are scrapped. Moreover, even though a cylinder's certification has expired, the federal regulations permit the owner of the cylinder to delay the recertification process when the cylinder still contains gas. Taxpayer does not test and recertify that cylinder, either. Therefore, unlike the roller bearings, cylinders continue to be used and to function even after their certifications have expired. Taxpayer further argues that replacing valves and/or components of valves prolong the duration of the cylinders' useful life. But, when cylinders fail the Test, Taxpayer does not replace them because Taxpayer has scrapped those failed cylinders. The replacement of valves and components performed by Taxpayer is therefore contemplated as a normal part of the life cycle of the existing cylinders.

In conclusion, Taxpayer failed to satisfy the first and the fourth prongs of Rotation Products. Therefore, pursuant to the above referenced statutes and the Rotation Products' interpretation of IC § 6-2.5-5-5.1 and IC § 6-2.5-5-3, Taxpayer is not entitled to exemptions regarding purchases of capital assets and materials consumed for work it performs on recertification of used cylinders.

FINDING

Taxpayer's protest on assessment of additional use tax is respectfully denied.

II. Sales and Use Tax – Calculation.

Taxpayer also protests the rate of error used in the calculation to assess Taxpayer's tax liability.

On July 3, 2008, Taxpayer agreed, in writing, to the Department's methodology of Projecting Audit Results. Pursuant to the agreement, the test period was January 1, 2007, through December 31, 2007. The auditor examined all purchases during the test period to determine errors in payment of sales and use tax. During the test period, purchases on which there was an error in payment of tax were used as the numerator in calculating the rate of error. Both Taxpayer and the Department also agreed that the denominator was the total expenses of the test period for accounts containing taxable purchases. As a result, the rate of error is 20.65 [percent].

Taxpayer argued that it is entitled to manufacturing exemptions and, therefore, some of the purchases during the test period were erroneously considered in the calculation. Thus, Taxpayer claimed that the rate of error, 20.65 [percent], is no longer valid. Taxpayer stated that the Department must recalculate the rate of error to assess Taxpayer's tax liability. However, Taxpayer failed to satisfy the first and the fourth part of Rotation Products' test to be considered a remanufacturer of cylinders. Taxpayer is not entitled to exemptions regarding purchases of capital assets and materials consumed for work it performs on recertification of used cylinders. As a result, Taxpayer's expenses on those purchases were correctly considered in calculating the rate of error.

FINDING

Taxpayer's protest of the rate of error used in calculation is respectfully denied.

III. Tax Administration – Penalty.

Taxpayer also protests the assessment of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1, the Department may assess a ten (10) percent negligence penalty if the taxpayer:

- (1) fails to file a tax return;
- (2) fails to pay the full amount of tax shown on the tax return;
- (3) fails to remit in a timely manner the tax held in trust for Indiana (e.g., a sales tax); or
- (4) fails to pay a tax deficiency determined by the Department to be owed by a taxpayer.

[45 IAC 15-11-2](#)(b) further states:

"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 Department may waive a negligence penalty as provided in [45 IAC 15-11-2](#)(c), in part, 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 demonstrated that it had reasonable cause to believe that it is entitled to the exemptions under the Rotation Products' test. Thus, Taxpayer's protest on the imposition of negligence penalty is sustained.

FINDING

Taxpayer's protest on imposition of negligence penalty is sustained.

SUMMARY

For the reasons discussed above, Taxpayer's protest on imposition of sales and use tax is respectfully

denied. Additionally, Taxpayer's protest on calculation of rate of error is respectfully denied. But, Taxpayer's protest on imposition of negligence penalty is sustained.

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