

Supplemental Letter of Findings: 08-0141
Sales and Use Tax
For the Year 2006

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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); Indiana Dep't of Revenue v. Interstate Warehousing, Inc., 783 N.E.2d 248 (Ind. 2003).

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 supplies building materials for sale to commercial, farm, industrial, and residential customers in Indiana. Taxpayer's products include ready-mix concrete, concrete blocks, brick, landscaping items, septic tanks, and small tools. In 2006, Taxpayer purchased a wheel loader.

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. Taxpayer protested the imposition of the use tax assessment associated with the purchase of this loader. A hearing was held and a Letter of Findings denying Taxpayer's protest was issued. Taxpayer requested a rehearing on the basis that more extensive facts relating to the protest were now available. The Department granted the rehearing. This Supplemental 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 with an ST-105 (Indiana Department of Revenue Sales Tax Exemption Certificate) marked "manufacturing equipment used directly in direct production." 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 protested the imposition of use tax on the purchase of the wheel loader. Taxpayer argued that the loader is used directly in its direct processing 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. IC § 6-2.5-5 states other retail transactions that are exempt from sales and use tax.

Taxpayer contended that its use of the equipment qualified for an exemption, therefore, Taxpayer did not pay the sales tax at the time of purchase. Taxpayer asserted that the purchase of the equipment met the "double direct" production exemption. In its April 30, 2008, protest letter, Taxpayer states:

Aggregates moved by the loader have already been crushed, graded, and washed to meet standard specifications required in our manufacturing process. This makes them work-in-process. The loader moves and places them directly from temporary storage into the machinery that processes them into different types of concrete. Thus the loader is like the forklift in [\[45 IAC 2.2-5-8\]](#).

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 cited 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. *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.

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.

The issue on rehearing remains whether Taxpayer's production process begins before the materials are introduced to the production hopper, thus exempting the loader that transports the materials to the hopper.

[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\(f\)](#) to which Taxpayer refers, describes the exemption status of transportation equipment used in the manufacturing process, and 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, 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).

At hearing Taxpayer explained that the crushing, grading, and washing of the materials is performed by Taxpayer's suppliers to Taxpayer's specifications. Taxpayer stated that these materials are then brought to its premises where the materials are stockpiled until removed by the loader and introduced to production. Taxpayer stated that because it owns the materials that come onto its premises, the materials are work-in-process. Therefore its loader is moving work-in-process and therefore should be exempt. Also, at rehearing, Taxpayer provided more detail about its process. Taxpayer stated that the loader was used for about three hours each day and estimated the percentage of time the loader was used for the various materials Taxpayer uses (stone, sand, and pea gravel). Taxpayer explained that the temperature and moisture level of each of the aggregates must be brought into and/or monitored for usable ranges throughout a given production day. For example, if a pile of aggregate is too dry or too wet, the loader is used to reform the pile of aggregate to the proper height, depth and width in order to allow Taxpayer to properly moisten or dry the aggregate. According to Taxpayer, optimal temperature and moisture levels must be achieved in order to produce the highest quality product.

As stated previously, the fact that something is done to the materials before they arrive on Taxpayer's premises and the fact that Taxpayer owns these materials at the time they arrive on its premises is not determinative that the production process has begun.

The first activity that constitutes the beginning of the integrated production process is the introduction of the materials to the hopper because this is when the materials begin to be substantially altered. The production process ends at the point that the production has altered the item to its completed form. Taxpayer objected at hearing that the use of "pre-production" and "post-production" terminology to remove items from the manufacturing exemption, was nothing more than "word games." Taxpayer is respectfully reminded that the intent of the legislature is that, 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. Exemption statutes are strictly construed against a taxpayer as long as the intent and purpose of the legislature is not thwarted, as provided in *Interstate Warehousing, Indiana Dep't of Revenue v. Interstate Warehousing, Inc.*, 783 N.E.2d 248, 250 (Ind. 2003). No matter how important the use of the loader is to maintain the aggregates in optimal temperature and moisture level ranges, the aggregates, while stored in piles, have not yet been introduced to the integrated process that begins to substantially transform the aggregates. [45 IAC 2.2-5-8\(g\)](#). For example, in a baked goods operation, refrigerators that are used to keep raw ingredients properly cooled are not exempt.

The Department correctly determined that processing does not begin until the aggregates are introduced into the hopper because prior to that time the aggregates have not been substantially changed in an integrated, continuous process. Therefore the use of the loader is not exempt.

FINDING

Taxpayer's protest is respectfully denied.

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.

Upon rehearing Taxpayer has 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 sustained.

CONCLUSION

Taxpayer's protest of the use tax assessment is still denied.

Taxpayer's protest of the penalty is now sustained.

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