DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 08-0477
Use Tax
For Tax Years 2004-06

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ISSUES

I. Use Tax–Imposition.

Authority: IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; 45 IAC 2.2-4-13.

Taxpayer protests the assessment of use tax.

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.

STATEMENT OF FACTS

Taxpayer is an Indiana corporation in the furniture industry. In 2004, Taxpayer relocated from its original plant, which was substantially damaged in a natural disaster, to its new plant. Most of Taxpayer's records were destroyed in the natural disaster, as was most of the heavy production equipment. The result of this was that Taxpayer changed its manufacturing operations, from making the furniture starting with raw materials and ending with finished goods, to primarily finishing and assembling components delivered from other manufacturers. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed additional use tax for the tax years 2004, 2005, and 2006. The Department issued proposed assessments for use tax, interest and ten percent negligence penalties. Taxpayer protests portions of the proposed assessments. Taxpayer also protests the negligence penalty. Further facts will be supplied as required.

I. Use Tax–Imposition.

DISCUSSION

Taxpayer protests two adjustments which resulted from the Department's audit. First, Taxpayer protests that the sample and projection method used by the Department made adjustments for sales when there were no invoices available. Taxpayer protests that the invoices, which showed that sales tax was either paid at the point of purchase or was not due under the manufacturing exemption, were destroyed in the natural disaster which damaged their original plant and heavy manufacturing machinery. Second, Taxpayer protests the imposition of use tax on utilities which it believes were used predominantly in its manufacturing processes. Taxpayer states that it has been in the manufacturing business since its inception and that it continued as primarily a manufacturer after it moved to its new plant. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

Taxpayer's first point of protest is the Department's inclusion of purchases in the Department's sample and projection method which had no invoices available for review. Taxpayer explained that the invoices were destroyed in the natural disaster which damaged its original factory in 2004. Taxpayer believes that the invoices would have shown that sales tax was either not due because of the manufacturing exemption or was paid at the point of purchase. Taxpayer argues that the inclusion of those purchases in the projection method incorrectly raises the percentage of purchases upon which use tax is due.

The Department used the best information available to reach its determinations, as provided by IC § 6-8.1-5-1(b). While it is understandable that the invoices were destroyed, the Department has no other documentation to work with in this case. With such a lack of documentation, the Department must rely on the best information available. That information was therefore properly included in the projection calculations.

The second point of protest is the Department's determination that Taxpayer was not entitled to the predominant use exemption for utilities used in its business. The Department allowed some exemption on utilities as provided by IC § 6-2.5-5-5.1, which states:

> (a) As used in this section, "tangible personal property" includes electrical energy, natural or artificial gas, water, steam, and steam heat.
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> (b) 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. This exemption includes transactions involving acquisitions of tangible personal property used in commercial printing.

The Department used the available documents and determined that Taxpayer was involved in some manufacturing activities and was therefore entitled to exemption from sales and use tax on certain percentages of its utility purchases under IC § 6-2.5-5-5.1. Taxpayer protests that it is entitled to the predominant use exemption

found at 45 IAC 2.2-4-13, which states:

(a) In general, the furnishing of electricity, gas, water, steam, or steam heating services by public utilities to consumers is subject to tax.

(b) The gross receipt of every person engaged as a power subsidiary or a public utility derived from selling electrical energy, gas, water, or steam to consumers for direct use in direct manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in IC 6-2.5-4-5 shall not constitute gross retail income of a retail merchant received from a retail transaction. Electrical energy, gas, water, or steam will only be considered directly used in direct production, manufacturing, mining, refining, oil or mineral extraction, irrigation, agriculture, or horticulture if the utilities would be exempt under IC 6-2.5-5-5.1.

(c) Sales of public utility services or commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in IC 6-2.5-4-5, based on a single meter charge, flat rate charge, or other charge, are excepted if such services are separately metered or billed and will be used predominantly for the excepted purposes.

(d) Sales of public utility services and commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, or horticulture, based on a single meter charge, flat rate charge, or other charge, which will be used for both excepted and nonexcepted purposes are taxable unless such services and commodities are used predominantly for excepted purposes.

(e) Where public utility services are sold from a single meter and the services or commodities are utilized for both exempt and nonexempt uses, the entire gross receipts will be subject to tax unless the services or commodities are used predominantly for excepted purposes. Predominant use shall mean that more than fifty percent (50%) of the utility services and commodities are consumed for excepted uses.

(Emphasis added.)

Due to the change in Taxpayer's location and activities after the natural disaster, the Department determined that Taxpayer's activities no longer qualified for the predominant use exemption. Again, much of Taxpayer's records were destroyed in the natural disaster in 2004. Also, Taxpayer explained that it was undergoing a period of transition at the time of the audit, which it believes resulted in a lack of communication between Taxpayer and the Department. Taxpayer feels that this lack of communication resulted in the Department misunderstanding the nature of Taxpayer's operations. Taxpayer asserts that it is still entitled to the predominant use exemption found at 45 IAC 2.2-4-13(e), and provided additional documentation in support of this position.

Upon review, the available documentation does not meet the requirement that Taxpayer prove the proposed assessments wrong. While the documentation does establish that Taxpayer is involved in some manufacturing activities, it does not establish that these activities are not already accounted for in the amounts which the Department agreed were exempt. Therefore, Taxpayer has not met the burden imposed under IC § 6-8.1-5-1(c).

In conclusion, Taxpayer has not provided and/or does not have invoices to prove the Department's sample and projection method wrong. Many of those invoices were destroyed in a natural disaster. While the Department is aware of this circumstance, it is constrained by the language of the tax code, and must use the best information available to it. In this case, the best information does not support Taxpayer's position. Also, the best information available does not support Taxpayer's claim for the predominant use exemption for utilities. If Taxpayer conducts, or hires a qualified third party to conduct, a utility study supporting the predominant use protest, such a study may be submitted in a rehearing request. The Department will review the study in determining if a rehearing is warranted.

FINDING

Taxpayer's protest is denied.

II. Tax Administration–Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax year in question. Taxpayer protests the imposition of penalty. The Department refers to IC § 6-8.1-10-2.1(a), which states in relevant part:

If a person:

. . .

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

. . .

the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which 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.

45 IAC 15-11-2(c) provides in pertinent part:

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 incurred severe losses of material and customers as the result of a natural disaster. Taxpayer has established that its failure to pay the deficiency 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 is denied regarding Issue I and the imposition of use tax. Taxpayer is sustained regarding Issue II and the imposition of the ten percent negligence penalty.

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