

Letter of Findings Number: 09-0159
Sales and Use Tax
Tax Years 2006 - 2007

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ISSUES

I. Sales and Use Tax—Manufacturing Exemption.

Authority: IC § 6-2.5-3-2; IC § 6-8.1-5-1; IC § 6-2.5-5-3; IC § 6-2.5-5-4; IC § 6-2.5-5-5.1; [45 IAC 2.2-5-8](#); Indiana Dep't of Revenue v. Kimball Int'l, Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); General Motors Corp. v. Indiana Dep't of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991).

Taxpayer protests the assessment of use tax on certain of its purchases.

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 (10) percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is engaged in processing lumber into hardwood products. Taxpayer purchases standing trees, which are felled by a contractor prior to transport to Taxpayer's mill. After an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed use tax and assessed a negligence penalty for the 2006 and 2007 tax years. The Department found that Taxpayer had made a variety of purchases on which Indiana sales tax was not paid at the time of purchase nor was use tax remitted to the Department. Taxpayer protested the imposition of use tax and penalty on the purchase of certain equipment and materials. An administrative hearing was held, and this Letter of Findings results.

I. Sales and Use Tax—Manufacturing Exemption.

DISCUSSION

Pursuant to IC § 6-8.1-5-1(b), all tax assessments are presumed to be accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

The Department found that Taxpayer had made several purchases for which Indiana sales tax was not paid at the time of purchase nor was use tax remitted to the Department. The Department assessed use tax on these purchases, including Taxpayer's purchases of kerosene heating oil, welding supplies, tree-marking paint, and lumber crayons. The Department determined that these items were purchased for use in pre-production and non-production activities and were subject to use tax. Indiana imposes "an excise tax, known as the use tax," on tangible personal property that is acquired in retail transactions and is stored, used, or consumed in Indiana. IC § 6-2.5-3-2(a).

Taxpayer maintains that, as a manufacturer of lumber and hardwood products, its purchases of certain materials and equipment are used for production activities and are subject to a sales and use exemption under IC § 6-2.5-5.

IC § 6-2.5-5-3(b) provides an exemption from sales and use tax for "manufacturing machinery, tools, and equipment... if the person acquiring the property acquires it for direct use in the direct production [or] manufacture... of other tangible personal property."

Property acquired for "direct use in the direct production" is defined in [45 IAC 2.2-5-8\(c\)](#) as "manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process" that have "an immediate effect on the article being produced." Property has "an immediate effect" when it becomes "an essential and integral part of the integrated process which produces tangible personal property." [45 IAC 2.2-5-8\(c\)](#).

[45 IAC 2.2-5-8\(d\)](#) excludes pre-production and post-production activities by providing that "'direct use in the production process' begins at the point of 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 complete form."

IC § 6-2.5-5-4 provides an exemption for "[t]ransactions involving tangible personal property... if the person acquiring the property acquires it for his direct use in the direct production of the machinery, tools, or equipment described in [[45 IAC 2.2-5-8\(c\)](#)]." IC § 6-2.5-5-4.

IC § 6-2.5-5-5.1 allows for the exemption of "tangible personal property... 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 [or] processing..." IC § 6-2.5-5-5.1(b). As used in 6-2.5-5-5.1(b), "'tangible personal property,' includes electrical energy, natural or artificial gas, water, steam, and steam heat." IC § 6-2.5-5-5.1(a).

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of

taxation and against the exemption." *Indiana Dep't of Revenue v. Kimball Int'l, Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

A. Kerosene

The Department found that Taxpayer had purchased kerosene without paying sales tax at the time of purchase and assessed use tax. The Department determined that the kerosene was used to fuel equipment warming the production facilities for the comfort of employees.

Taxpayer asserts that the primary purpose of the kerosene-fueled heating equipment is to warm air lines, hydraulic tanks, and hoses attached to production machinery to prevent them from freezing during periods of colder temperatures each year. According to Taxpayer, any heating effect on employees is a secondary benefit but entirely unnecessary, as the employees' clothing and physical activity keep them warm enough to alleviate the need for supplemental heat. Photo documentation was provided to show locations and examples of this equipment being used to heat parts of the production machinery.

[45 IAC 2.2-5-12\(e\)](#) states:

Purchases of materials to be consumed during the production or mining process are exempt from tax, if the consumption of such materials has an immediate effect upon the article being produced and mined, or upon machinery, tools, or equipment which are both used in the direct production or mining process and are exempt from tax under these regulations.

Accordingly, if the heating equipment consuming the kerosene fuel here is exempt production equipment, the fuel would likewise be exempt. The equipment exemption in IC § 6-2.5-5-3(b) is relevant here. Courts have interpreted this statute as creating a "double-direct" test, whereby equipment is exempt only if it is "essential and integral" to an integrated production process. *General Motors Corp. v. Indiana Dep't of State Revenue*, 578 N.E.2d 399, 401 (Ind. Tax Ct. 1991).

Based on supporting explanations and documentation from Taxpayer, the heating equipment used in conjunction with the exempt production machinery is likely essential and integral for colder periods during the year. The production facility has open-air sides, and it is possible that cold air could cause the oil to gel in the lines or affect hydraulic components, as Taxpayer claims. Moreover, the location of the heating equipment is such that it is targeting the machinery and not near an area from which employees would operate the machinery.

Based upon documentation provided, Taxpayer has met its burden of proving that the heating equipment is essential and integral to the production process. Since fuel consumed by exempt equipment is exempt, Taxpayer's protest is sustained as to the kerosene purchases for this particular purpose.

B. Welding Supplies

The Department found that Taxpayer purchased various welding supplies without paying sales tax and assessed use tax. Taxpayer asserts that these supplies are used to build replacement parts and attachments for production machinery and should thus be exempt from sales and use tax under the production exemption in IC § 6-2.5-5-3(b). Taxpayer explains that normal repair and maintenance is contracted to an outside provider and not performed in-house using the welding equipment at issue. Taxpayer has submitted photographs of equipment purportedly built with the use of the welding supplies at issue, which include a welder's safety mask.

IC § 6-2.5-5-4 provides an exemption for "[t]ransactions involving tangible personal property... if the person acquiring the property acquires it for his direct use in the direct production of the machinery, tools, or equipment described in [\[45 IAC 2.2-5-8\(c\)\]](#)." IC § 6-2.5-5-4.

Taxpayer has failed to meet its burden of proof as to the use of the welding supplies. Even when Taxpayer's account is taken as fact, the welding supplies are not exempt equipment. [45 IAC 2.2-5-8\(h\)\(1\)](#) specifically addresses maintenance equipment and states that "[m]achinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax." Since the installation of replacement parts is considered to be a "normal repair and maintenance" function, the welding supplies used in the installation of replacement parts are not exempt from sales and use tax. Therefore, Taxpayer's protest is respectfully denied as to these items.

C. Tree-marking Paint and Lumber Crayons

The Department found that Taxpayer purchased tree-marking paint and "lumber crayons" without paying sales tax and assessed use tax. According to Taxpayer, the paint and crayons are used to identify which trees to cut. The markings also aid inventory control. Taxpayer asserts that this activity falls within the bounds of their production process, qualifying the paint and markers for exemption from sales and use tax under the manufacturing exemptions in IC § 6-2.5-5-3(b).

[45 IAC 2.2-5-8\(d\)](#) explains that pre-production and post-production activities are excluded from the manufacturing exemption and states that "'[d]irect use in the production process' begins at the point of 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 complete form."

The tree-marking paint and lumber crayons are used by Taxpayer prior to the logging contractor's felling of the marked trees and the subsequent shipment of the trees to Taxpayer's production facility. Therefore, the paint and crayons are used before Taxpayer's integrated production process begins. Further, these supplies are not essential and integral parts of the production process because they do not play a direct role in altering the trees

into a new form. While these items may provide convenience to both Taxpayer and its logging contractor, they are merely management tools used in Taxpayer's pre-production activities. Therefore, these items do not qualify for a manufacturing exemption, and Taxpayer's protest is denied.

FINDING

Taxpayer's protest is sustained for Subpart A. Taxpayer's protest is denied for subparts B and C.

II. Tax Administration–Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and ten (10) percent negligence penalties for the tax years in question. Taxpayer protests the imposition of the penalties. The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides "if a person... 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.

The Department may waive a negligence penalty as provided in [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.

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 has not affirmatively established that its failure to pay the remaining deficiencies was due to reasonable cause and not due to negligence, as required by [45 IAC 15-11-2\(c\)](#).

FINDING

Taxpayer's protest to the imposition of the penalty is respectfully denied.

CONCLUSION

In summary, Taxpayer's protest is sustained for Issue I(A), and Taxpayer's protest is denied for Issues I(B), I(C), and II.

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