DEPARTMENT OF STATE REVENUE

04-20090311.LOF

Letter of Findings Number: 09-0311
Sales and Use Tax
For Tax Years 2006-07

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Sales and Use Tax–Manufacturing Exemption.

Authority: Indiana Dep't of Revenue v. Interstate Warehousing, Inc., 783 N.E.2d 248 (Ind. 2003); Rotation Products Corp. v. Indiana Dep't of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998); IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-7; IC § 6-2.5-5-3; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1.

Taxpayer protests the imposition of sales tax and use tax and claims that it is eligible for the manufacturing exemption.

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 business which sells scrap metal and various used items such as industrial equipment, signs, antiques, and other items. Taxpayer also provides equipment rental, demolition and excavating services, and occasionally sells recycled cement. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed sales and use taxes for the tax years 2006 and 2007. The Department therefore issued proposed assessments for sales and use taxes, ten percent negligence penalties, and interest for those years. Taxpayer protests the imposition of sales and use taxes and the negligence penalties. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Sales and Use Tax–Manufacturing Exemption.

DISCUSSION

Taxpayer protests the imposition of sales and use taxes on some of the purchases it made during the tax years 2006 and 2007. Taxpayer claims that its recycling activities constitute manufacturing. Taxpayer disassembles articles for the scrap components, usually consisting of the various metals in the articles, which Taxpayer then sells to scrap buyers. Taxpayer states that purchases of tangible personal property ("TPP") it made were not subject to sales tax because Taxpayer believes that it is eligible for the manufacturing exemption. Taxpayer protests that, since sales tax was not due on those purchases, use tax is not due on those purchases. Taxpayer also states that it had an exemption certificate for sales to one customer and believes that it was not required to collect sales tax on that sale. 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).

The first relevant statute is IC § 6-2.5-2-1, which states:

(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.

Also, Indiana imposes a complementary use tax under IC § 6-2.5-3-2(a), which states:

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.

Next, IC § 6-2.5-3-7 states:

(a) A person who acquires tangible personal property from a retail merchant for delivery in Indiana is presumed to have acquired the property for storage, use, or consumption in Indiana. However, the person or the retail merchant can produce evidence to rebut that presumption.

(b) A retail merchant is not required to produce evidence of nontaxability under subsection (a) if the retail merchant receives from the person who acquired the property an exemption certificate which certifies, in the form prescribed by the department, that the acquisition is exempt from the use tax.

(c) A retail merchant that sells tangible personal property to a person that purchases the tangible personal property for use or consumption in providing public transportation under IC 6-2.5-5-27 may verify the exemption by obtaining the person's:

(1) name;

(2) address; and

(3) motor carrier number, United States Department of Transportation number, or any other identifying number authorized by the department.

The person engaged in public transportation shall provide a signature to affirm under penalties of perjury that the information provided to the retail merchant is correct and that the tangible personal property is being purchased for an exempt purpose.

(Emphasis added).

Next, IC § 6-2.5-5-3 states:

(a) For purposes of this section:

(1) the retreading of tires shall be treated as the processing of tangible personal property; and

(2) commercial printing shall be treated as the production and manufacture of tangible personal property.

(b) Except as provided in subsection (c), 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.

(c) The exemption provided in subsection (b) does not apply to transactions involving distribution equipment or transmission equipment acquired by a public utility engaged in generating electricity.

(Emphasis added).

Finally, IC § 6-2.5-5-5.1 provides:

(a) As used in this section, "tangible personal property" includes electrical energy, natural or artificial gas, water, steam, and steam heat.

(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.

Therefore, the TPP must be directly used in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property in order to be exempt from sales tax under either IC § 6-2.5-5-3 or IC § 6-2.5-5-5.1(b).

The Indiana Supreme Court has provided guidance on this issue in Indiana Dep't of Revenue v. Interstate Warehousing, Inc., 783 N.E.2d 248 (Ind. 2003). The Indiana Supreme Court explained that the Indiana Tax Court had addressed the exemption in several prior cases. The court stated:

The common thread in all of these cases is that where the taxpayer did not transform property into a distinct marketable product for customer consumption, the Tax Court held that the taxpayer was not engaged in the "production of other tangible personal property." We agree with the Tax Court's analysis in those cases.

Id. at 251.

As provided above by the court in Interstate Warehousing, any taxpayer claiming the exemption provided by IC § 6-2.5-5-5.1 must transform property into a distinct marketable product for customer consumption in order to qualify for the exemption. This requirement also applies to the exemption provided by IC § 6-2.5-5-3.

Also, the Indiana Tax Court has provided guidance when determining what constitutes manufacturing. In Rotation Products Corp. v. Indiana Dep't of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998), that taxpayer claimed that it was remanufacturing ball bearings and was therefore eligible for the manufacturing exemption. The court explained:

Usually, a substantial amount of work will have to be performed to transform materials with only scrap value into serviceable and marketable products. In most cases, the substantial amount of work required will "result in an 'end product' that is 'substantially different from the component materials used.'"

Id., at 802.

In Rotation Products, the discussion focused on whether or not remanufacturing constituted manufacturing as used in the exemption statutes. While this protest concerns a recycling operation instead of a remanufacturing operation, a review of the court's reasoning is helpful. The court provided a four-part test to answer the question of how to determine if a taxpayer is in the business of manufacturing, as follows:

The case law reveals three factors germane to this fact-sensitive inquiry. The first is an adaptation of the requirement of a substantially different end product: 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. The other two factors derive from the observations of the courts dealing with this issue: a comparison of the article's value before and after the work, and how favorably the performance of the remanufactured article compares with the performance of newly manufactured articles of its kind. Additionally, this Court concludes that another factor is applicable to this inquiry: whether the work performed was contemplated as a normal part of the life cycle of the existing article. This additional factor will prevent work that merely perpetuates existing products from qualifying for an industrial exemption.

Id., at 802-3.

The first factor weighs the substantiality and complexity of the work done on the existing article, including the addition of new parts. In the instant case, Taxpayer does not add new parts to the articles being disassembled, but instead removes parts and separates them into groupings defined by their material composition. The disassembled parts themselves have no value as parts. The only value is the metal or other recyclable content. The recyclable materials have no functionality and, after removal from the original article, have no value as parts. Since there is no new article produced, Taxpayer's activities do not pass the first factor of the Rotation Products test and review of the other factors is unnecessary. Therefore, under Interstate Warehousing, Taxpayer's activities do not qualify for the manufacturing exemption provided under IC § 6-2.5-5-3. Therefore, Taxpayer should have paid sales tax on the items at the time of purchase. Since sales tax was not paid, use tax was properly imposed.

Taxpayer also states that it had an exemption certificate for a sale it made to a customer which means that it was not required to collect sales tax on that sale. Taxpayer has provided a copy of the exemption certificate. Therefore, under IC § 6-2.5-3-7(b) Taxpayer is correct and the $9,600 of sales to that customer in 2006 will be removed from the amount of taxable sales upon which Taxpayer should have collected sales tax as a retail merchant.

In conclusion, Taxpayer's activities do not constitute manufacturing as provided by Interstate Warehousing and Rotation Products. Sales tax should have been paid on the items in question at the time Taxpayer purchased them. Since sales tax was not paid, use tax was properly imposed. Taxpayer produced an exemption certificate from one of its customers and the amount of that sale will be removed from the amount of taxable sales upon which Taxpayer should have collected sales tax as a retail merchant. The protest file will be subject to a supplemental audit to recalculate sales and use taxes after the removal of the sale for which Taxpayer produced the exemption certificate.

FINDING

Taxpayer's protest is denied in part, since it is ineligible for the manufacturing exemption. Taxpayer's protest is sustained in part, since it has produced an exemption certificate from one of its customers.

II. Tax Administration–Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax years 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). As explained in Issue I, Taxpayer was not eligible for the manufacturing exemption. Taxpayer has not affirmatively 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). However, Taxpayer was partially sustained in Issue I, since it had an exemption certificate from one of its customers. The penalty will remain, but will be recalculated based on the lower sales and use tax assessments as provided in Issue I.

FINDING

Taxpayer's protest is denied.

CONCLUSION

Taxpayer's protest is denied on Issue I regarding eligibility for the manufacturing exemption. Taxpayer's protest is sustained on Issue I regarding the exemption certificate for one customer. Taxpayer's protest is denied

on Issue II regarding imposition of negligence penalties.

Posted: 11/25/2009 by Legislative Services Agency
An html version of this document.