DEPARTMENT OF STATE REVENUE

04-20090014.LOF

Letter of Findings Number: 09-0014
Sales and Use Tax
For Tax Years 2005-06

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 It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register.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–Imposition.

Authority: 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; 45 IAC 2.2-5-8; Indiana Dep't of Revenue v. Interstate Warehousing, Inc., 783 N.E.2d 248 (Ind. 2003); Indiana Dep't of Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983); North Cent. Industries, Inc., Company v. Indiana Dep't of Revenue, 790 N.E.2d 198 (Ind. Tax Ct. 2003); Rotation Products Corp. v. Dep't of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998); Indianapolis Fruit Company v. Indiana Dep't of State Revenue, 691 N.E.2d 1379 (Ind. Tax Ct. 1998); Mid-America Energy Resources v. Indiana Dep't of State Revenue, 681 N.E.2d 259 (Ind. Tax Ct. 1997); Harlan Sprague Dawley v. Indiana Dep't of State Revenue, 605 N.E.2d 1222 (Ind. Tax Ct. 1992).

Taxpayer protests the imposition of use tax claiming 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 company in the waste disposal and recycling business. Taxpayer collects, sorts, and resells recyclable materials. Taxpayer at one Indiana location collects from curbside recycling bins plastic, glass, paper, cardboard, and aluminum materials. Taxpayer, at another Indiana location, recovers construction debris, such as metal and cardboard, which it shears, bales, and sells to metal and paper mills. Taxpayer has a third Indiana facility that recovers commercial cardboard and paper that it sorts, grades, bales, and sells to paper mills. After an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed use tax and assessed a negligence penalty for the 2005 and 2006 tax years. The Department found that Taxpayer had made a variety of purchases–including office supplies, computer software, freight/delivery charges, cleaning supplies, equipment, tools, and storage containers–upon which Taxpayer neither paid sales tax at the time of purchase nor remitted use tax to the Department. Further facts will be supplied as required.

I. Sales and Use Tax–Imposition.

DISCUSSION

Taxpayer protests the imposition of sales and use taxes on certain of its purchases. Taxpayer claims that its recycling activities constitute "manufacturing." Taxpayer recovers, through curbside recycling and office paper recycling, plastic, glass, aluminum, cardboard, and paper. Taxpayer also disassembles construction scrap components, usually consisting of the various metal and cardboard articles, which Taxpayer then sells to mills. Taxpayer asserts that it sorts, sizes, cleans, and/or bales, cubes, or bundles these recycling materials. Taxpayer maintains that this process results in a new, more marketable product and that Taxpayer is therefore entitled to the exemption found in IC § 6-2.5-5-3(b). Taxpayer states that its equipment purchases were not subject to sales and use tax because Taxpayer believes that it is eligible for the manufacturing exemption. Taxpayer refers to several Indiana court cases in support of its position, including: Indiana Dep't of Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983), Rotation Products Corp. v. Indiana Dep't of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998); Harlan Sprague Dawley v. Indiana Dep't of State Revenue, 605 N.E.2d 1222 (Ind. Tax Ct. 1992), Indianapolis Fruit Company v. Indiana Dep't of State Revenue, 691 N.E.2d 1379 (Ind. Tax Ct. 1998), and Mid-America Energy Resources v. Indiana Dep't of State Revenue, 681 N.E.2d 259 (Ind. Tax Ct. 1997). Taxpayer also states that it has certain invoices that were not provided during the audit that show the payment of sales tax at the time of purchase; therefore, use tax should not be assessed on those purchases. 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 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.

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

Next, IC § 6-2.5-3-7(a) provides:

(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.

Next, IC § 6-2.5-5-3 provides:

(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.

Further, the Department refers to 45 IAC 2.2-5-8(k), which states:

"Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance as a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change, and it must result in a transformation of property into a different product having a distinctive name, character, and use. Operations such as compounding, fabricating, or assembling are illustrative of the types of operations which may qualify under this definition.

Accordingly, the property 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. 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; in most cases, Taxpayer merely separates and "repackages" the items. Taxpayer, at most, removes parts, separates items into groupings defined by their material composition, cleans items, and/or crushes items before bundling them into cubes-i.e., an all plastic cube or an all paper cube. The recyclable materials have no functionality as products, but only have value as the plastic, paper, metal, or other recyclable content. Taxpayer starts with scrap paper, plastic, and glass and then ends with scrap paper, plastic, and glass. Taxpayer does not create a new product–i.e., such as a new alloyed metal. Thus, while Taxpayer's customers may prefer to purchase only in cubes or bundles and pay Taxpayer for the convenience of these services, Taxpayer has merely repackaged the existing recyclable material. The Tax Court addressed the issue of repacking in North Cent. Industries, Inc., Co. v. Indiana Dep't of State Revenue, 790 N.E.2d 198, 201 (Ind. Tax Ct. 2003) and explained that "merely packag[ing] existing [property]... is not the sort of substantial change or transformation that places property 'in a form, composition, or character different from that in which [they were] acquired.' 45 IAC 2.2-5-8(k)."

Accordingly, 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. 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 has invoices not provided during the audit that demonstrate that sales tax was paid on certain purchases on which use tax is now being assessed. Taxpayer has provided copies of those invoices. Therefore, Taxpayer's assessment will be adjusted to the extent that the assessment is based upon purchases on which Taxpayer had provided invoices demonstrating that sales tax was paid at the time of purchase.

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 certain invoices demonstrating that sales tax was paid at the time of purchase, and the amounts of those purchases will be removed from the amount of taxable purchases upon which Taxpayer should have remitted use tax. The protest file will be subject to a supplemental audit to recalculate use taxes to the extent that use tax has been assessed on purchases on which sales tax was paid at the time of the purchase.

FINDING

Taxpayer's protest is denied in part, since it is ineligible for the manufacturing exemption. Taxpayer's protest is sustained in part, to the extent that the invoices demonstrate that sales tax was paid at the time of purchase.

II. Tax Administration–Negligence Penalty.

DISCUSSION

Taxpayer protests 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.

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 deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c). As explained in Issue I, Taxpayer was not eligible for the manufacturing exemption. However, Taxpayer was partially sustained in Issue I since it had certain invoices reflecting the payment of sales tax at the time of purchase. The penalty will remain, but will be recalculated based upon the lower use tax assessments following the removal of the purchases as provided in Issue I.

FINDING

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

CONCLUSION

Taxpayer's protest to the imposition of use tax is denied in part, since it is ineligible for the manufacturing exemption. Taxpayer's protest to the imposition of tax is sustained in part, to the extent that the invoices demonstrate that sales tax was paid at the time of purchase. Taxpayer's protest to the imposition of penalty is denied, but the penalty will be recalculated based upon the lower use tax assessments following the removal of the purchases where sales tax was paid at the time of purchase as provided above.

Posted: 12/23/2009 by Legislative Services Agency
An html version of this document.