

Letter of Findings: 09-0053
Sales and Use Tax
For the Years 2005, 2006, and 2007

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ISSUES

I. Sales and Use Tax – Exemptions.

Authority: IC § 6-2.5-1-1 et seq.; IC § 6-2.5-3-4; 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](#); [45 IAC 2.2-5-11](#); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974).

Taxpayer protests the assessment of tax on purchases of tangible personal property.

II. Tax Administration – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana company that manufactures air distribution products and venting solutions for both residential and commercial applications. Pursuant to an audit, the Indiana Department of Revenue ("Department") assessed Taxpayer additional use tax, interest, and penalty on certain purchases during the tax years 2005, 2006, and 2007 because Taxpayer did not pay sales tax at the time of the transactions nor did it self-assess and remit use tax to the Department. Taxpayer timely protested the assessments. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Exemptions.

DISCUSSION

The Department's audit assessed Taxpayer use tax on purchases of tangible personal property, including, but not limited to, stock pickers, turret stock pickers, fork trucks and parts, decoilers, rack equipment (rackings), gloves, a barcode scanner, a computer software program, prototype parts, a replacement part for a label printer, air compressor and parts, a replacement of a control panel for a magnetic drill, battery connectors, replacement parts for an overhead crane, a power washer, as well as a stretch wrap machine. Taxpayer, to the contrary, claimed that it was entitled to exemptions.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; 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).

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. Generally, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable. [45 IAC 2.2-5-8\(a\)](#). An exemption from 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. There are also additional exemptions from sales tax and use tax. A statute which provides a tax exemption, however, is strictly construed against the taxpayer. Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96, 97 (Ind. Ct. App. 1974).

A. Manufacturing Exemption

IC § 6-2.5-5-3(b) states:

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.

IC § 6-2.5-5-5.1(b) provides:

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.

An exemption applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. [45 IAC 2.2-5-8\(a\)](#). 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 piece of 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 2.2-5-11](#), in part, 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.

[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.

[45 IAC 2.2-5-8\(f\)](#) provides:

(1) Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.

(2) Tangible personal property used for moving finished goods from the plant after manufacture is subject to tax.

(3) Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.

(4) Transportation equipment used to transport work-in-process, semi-finished, or finished goods between plants is taxable, if the plants are not part of the same integrated production process.

[45 IAC 2.2-5-8\(g\)](#) further states:

"Have an immediate effect upon the article being produced": Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit. The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced". Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property.

To support its protest, Taxpayer provided photos of a stock picker, a turret stock picker, a stretch wrap machine, a die rack, and rackings. Taxpayer also provided a video clip of a working decoiler. Taxpayer, however, did not demonstrate or document the exempt use of the tangible personal property to support its contentions on the percentage of exempt use for certain equipment and accessories, including, but not limited to, repair parts, propane, oil, Argon-CO2-25[percent]. Briefly describing its manufacturing process, Taxpayer directed the Department's attention to the following purchases of the tangible personal property and believed that exemptions applied. Thus, this Letter of Findings addresses Taxpayer's protest concerning its itemized purchases contained in its statement:

1. Decoilers

Taxpayer's documentation showed that it used the decoilers to unroll the coils—the raw materials. Unrolling the coils was pre-production and, thus, the decoilers were not exempt from sales and/or use tax pursuant to [45 IAC 2.2-5-8](#).

2. Stock Pickers and Turret Stock Pickers (Stock Pickers)

Taxpayer stated that it utilized the stock pickers to pull its products from one staging area and place them in another staging area.

When Taxpayer used the stock pickers to pull and/or move the raw materials, its use of the stock pickers was

pre-production and, thus, was not exempt. Additionally, when Taxpayer used the stock pickers to pull and/or move the finished products, its use of the items was post-production and, thus, was not exempt. Only when Taxpayer used the stock pickers to pull and/or move "work-in-process" to the next production stage, would the use of the stock pickers be considered as an essential and integral part of the integrated production process, and, therefore, exempt.

In this instance, Taxpayer's documentation only showed the appearance of the stock pickers without demonstrating its claim that the stock pickers were directly used in pull and/or "work-in-process." Thus, Taxpayer was not entitled to exemption.

3. Fork Trucks (Percentage Use)

The Department's audit granted a 50 percent exemption on Taxpayer's use of the fork trucks. Taxpayer, to the contrary, claimed that it was entitled to a 75 percent exemption. Taxpayer, however, failed to provide sufficient documentation to substantiate its claim and demonstrate the use of fork trucks added to a 75 percent exemption.

4. Parts for Forklifts and Repair Kit (Percentage Use)

The Department's audit granted a 50 percent exemption on the purchases of the parts and repair kits for items it argued are exempt. Taxpayer, to the contrary, claimed that it was entitled to an 83 percent exemption. Taxpayer, however, failed to provide sufficient documentation to substantiate its claim and demonstrate the use of forklifts added to an 83 percent exemption.

5. Propane and Oil (Percentage Use)

The Department's audit granted a 50 percent exemption on the use of the propane and oil which Taxpayer used for equipment, including forklifts and fork trucks. Taxpayer argued that it was entitled to an 83 percent exemption. Taxpayer, however, failed to provide sufficient documentation to substantiate its claim and demonstrate the use of the propane and oil added to an 83 percent exemption.

6. Argon-CO2-25 [percent] (Percentage Use)

The Department's audit granted a 50 percent exemption on the use of the Argon-CO2-25 [percent] which Taxpayer used for the welders. Taxpayer argued that it was entitled to at least an 80 percent exemption. Taxpayer, however, failed to provide sufficient documentation to substantiate its claim and demonstrate the use of the Argon-CO2-25 [percent] added to an 80 percent exemption.

7. Barcode Scanner

Taxpayer claimed that it was entitled to the manufacturing exemption on the purchase of the barcode scanner. Additionally, Taxpayer stated that it purchased and used the barcode scanner to read the barcode on the products. The barcode scanner, however, did not function properly, and Taxpayer further stated that it never used the scanner.

Since the barcode scanner was not directly used in the direct production, Taxpayer was not entitled to the manufacturing exemption.

8. Replacement Part for Label Printer

Taxpayer argued that it was entitled to the manufacturing exemption on the purchase of a replacement part for its label printer. Taxpayer stated that the label printer applied labels to the finished products after the finished products were wrapped in plastic. Thus, Taxpayer's use of the label printer and the replacement part was post-production. It was not entitled to the manufacturing exemption.

9. Air Compressor and Parts

Taxpayer stated that it used the air compressor to supply air for the entire plant. Thus, the air compressor and parts were not directly used in the direct production. Therefore, air compressor and parts were not exempt.

10. Replacement of Control Panel for a Magnetic Drill

Taxpayer claimed that it used the magnetic drill to drill holes in bolster plates and dies and, therefore, a replacement panel for the drill was exempt. Taxpayer, however, failed to provide sufficient documentation showing that it directly used the item in direct production. Therefore, the purchase of a replacement control panel for the magnetic drill was not exempt.

11. Battery Connectors and Toggle Clamps (Percentage Use)

The Department's audit granted a 50 percent exemption on the use of the battery connectors and the toggle clamps. Taxpayer claimed that it was entitled to more than a 50 percent exemption because it used the battery connectors to charge the battery to be used in the electronic trucks, which were used to move "work-in-process." Taxpayer also claimed that it used toggle clamps on one of the fixtures, which held parts in place during welding.

Taxpayer, however, failed to provide sufficient documentation to substantiate its claim and demonstrate the use of the battery connectors and the toggle clamps was more than 50 percent exempt.

12. Parts for Overhead Crane

Taxpayer maintained that it was entitled to the manufacturing exemption on the purchase of replacement parts for the overhead crane because it used the overhead crane to move the coils—the raw materials. Since Taxpayer's use of the overhead crane is pre-production, the purchases of replacement parts for the overhead crane were not exempt.

13. Parts for Power Washer

Taxpayer stated that it purchased repair parts for a power washer, which was used to clean out tanks at the

paint line. Taxpayer stated that it assumed the purchases of the parts for the power washer were not exempt. This Letter of Findings clarified that Taxpayer correctly assumed that the power washer was not directly used in the direct production, and therefore, was not exempt.

14. X Nut and Y Nut for Taxpayer's Bridgeport Mill in the Tool Room

Taxpayer maintained that it was entitled to the manufacturing exemption on the purchases of the X nut and the Y nut for the mill in the tool room. Taxpayer did not provide sufficient documentation showing that the purchases were directly used in the direct production. Thus, Taxpayer was not entitled to the exemption.

15. Replacement Relay Used to Operate the Wells

Taxpayer maintained that it was entitled to the manufacturing exemption on the purchase of the replacement relay. Taxpayer claimed that replacement relay was used to operate the wells, which supplied cooling water to all the assembly line and the air compressors.

Although the supply of cooling water was essential for Taxpayer to produce its products, the relay was not directly used in the direct production. Pursuant to [45 IAC 2.2-5-8\(g\)](#), Taxpayer was not entitled to the manufacturing exemption.

16. Lube Spraying Equipment

Taxpayer stated that the lube spraying equipment added lubricant to the raw material prior to production. Thus, the use of the lube spraying equipment was pre-production and, therefore, was not exempt.

17. Computer Software Program

Taxpayer claimed that it purchased a computer software program and used it in the manufacturing process. However, Taxpayer failed to provide sufficient documentation to substantiate its claim.

18. Prototype Parts

Taxpayer claimed that it was entitled to the manufacturing exemption on the purchase of prototype parts. Taxpayer stated that it used the prototype parts to try out newly engineered designs to verify and ensure the proper function of the designs. Taxpayer maintained that without the use of prototypes, it would not be able to run any project.

Although the prototype parts were essential for Taxpayer to produce its products, they were not directly used in the direct production. Pursuant to [45 IAC 2.2-5-8 \(g\)](#), Taxpayer was not entitled to the manufacturing exemption.

19. Gloves

The Department's audit specifically noted that the gloves were used for non-production and, therefore, were taxable. Taxpayer, to the contrary, claimed that the gloves are used to protect the safety of employees. Taxpayer maintained that its employees, without wearing the gloves, were injured easily.

Example (2)(F) to [45 IAC 2.2-5-8 \(c\)](#) provides:

Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.

In this instance, Taxpayer provided a pair of used and a pair of new gloves as well as its product sample to emphasize the importance of protecting its employees. Taxpayer, however, failed to demonstrate that the gloves were required to allow its employees to participate in the production process without injury during production.

20. Rack Equipment (Rackings), Die Rack, and Machine Guards (Percentage Use)

The Department's audit assessed used tax on purchases of rackings, die rack, and machine guards. Taxpayer claimed that it was entitled to the manufacturing exemption.

[45 IAC 2.2-5-8\(e\)](#) states:

Storage equipment. Tangible personal property used in or for the purpose of storing raw materials or finished goods is subject to tax except for temporary storage equipment necessary for moving materials being manufactured from one (1) machine to another or from one (1) production step to another.

(1) Temporary storage. Tangible personal property used in or for the purpose of storing work-in-process or semi-finished goods is not subject to tax if the work-in-process or semi-finished goods are ultimately completely produced for resale and in fact resold.

(2) Storage containers for finished goods after completion of the production process are subject to tax.

(3) Storage facilities or containers for materials or items currently undergoing production during the production process are deemed temporary storage facilities and containers and are not subject to tax.

The Department's audit agreed that Taxpayer probably was entitled to a 75 percent exemption on the racking that Taxpayer used to store "work-in-process" or "semi-finished goods," which were "ultimately completely produced for resale and in fact resold."

Taxpayer, however, stated that the rack (\$933.40) was used for finished goods storage. Taxpayer's documentation also showed that the die rack was used to store raw materials and some equipment. Additionally, Taxpayer stated that it purchased the machine guards and used the machine guards to build the die rack.

The racks were exempt to the extent they were used to store "work-in-process." However, the use of the \$933.40 rack, the die rack, and the machine guards were items used in pre-production, post-production, and/or non-production and, therefore, these items were not exempt.

The Department will recalculate the assessment concerning the racking which Taxpayer used to store

"work-in-process" in a supplemental audit.

B. Non-returnable Containers and Packaging Materials

Pursuant to [45 IAC 2.2-5-16](#), the Department's audit exempted strapping material Taxpayer used to secure its products for shipping. However, the Department assessed use tax on Taxpayer's stretch wrap machine. Claiming that it was entitled to an exemption, Taxpayer argued that the "product will not arrive to the customer in a salable condition without using this machine."

[45 IAC 2.2-5-16](#), in pertinent part, states:

(a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers sold empty for refilling.

(c) The receipt from a sale by a retail merchant of the following types of tangible personal property are exempt from state gross retail tax:

(1) Nonreturnable containers and wrapping materials including steel strap and shipping pallets to be used by the purchaser as enclosures for selling tangible personal property.

Taxpayer's stretch wrap machine did not fall under the "nonreturnable containers and wrapping materials" exemption. [45 IAC 2.2-5-16](#) refers to the actual "nonreturnable containers and wrapping materials." Additionally, since this was a post-production process, Taxpayer's use of the stretch wrap machine in this context is outside the ambit of the manufacturing exemption that applies to tools and equipment directly used in the direct manufacturing process. Only the "nonreturnable containers and wrapping materials" themselves qualify for the exemption stated in [45 IAC 2.2-5-16](#), which is an exemption separate from the manufacturing exemptions.

Thus, Taxpayer was not entitled to exemption regarding the purchase of the stretch wrap machine under [45 IAC 2.2-5-16](#).

FINDING

Taxpayer's protest on the racking that was used to store "work-in-process" is sustained, but the remainder of Taxpayer's protest is respectfully denied.

II. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayer also protests the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1, the Department may assess a ten (10) percent negligence penalty if the taxpayer:

- (1) fails to file a tax return;
- (2) fails to pay the full amount of tax shown on the tax return;
- (3) fails to remit in a timely manner the tax held in trust for Indiana (e.g., a sales tax); or
- (4) fails to pay a tax deficiency determined by the Department to be owed by a taxpayer.

[45 IAC 15-11-2](#)(b) further 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), in part, 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.

Taxpayer failed to provide sufficient documentation establishing that its failure to pay tax or timely remit tax was due to reasonable cause and not due to negligence.

FINDING

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

SUMMARY

For the reasons discussed above, Taxpayer's protest on the racking that was used to store "work-in-process" is sustained. However, the remainder of Taxpayer's protest is respectfully denied.

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