DEPARTMENT OF STATE REVENUE

04-20090567.LOF

Letter of Findings: 09-0567
Use Tax
For the Years 2006 and 2007

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ISSUES

I. Use Tax – Imposition.

Authority: IC § 6-2.5-3-2; 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 2.2-4-13; 45 IAC 2.2-5-8; 45 IAC 2.2-5-13; 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. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988).

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

II. Tax Administration – Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of penalty.

STATEMENT OF FACTS

Taxpayer engages in arboriculture, horticulture, and floriculture. Taxpayer maintains and sells trees, shrubs, and plants as a retailer and as a wholesaler to landscapers. Taxpayer is also a retailer of lawn and garden supplies. After an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed additional use tax for the tax years 2006 and 2007 and made assessments of tax, interest, and penalty. The Department determined that Taxpayer made a variety of purchases on which the Indiana sales tax was not paid at the time of purchase nor was use tax remitted to the Department. Taxpayer protests the imposition of use tax on certain of its purchases. An administrative hearing was held, and this Letter of Findings results. Further facts will be provided as necessary.

I. Use Tax – Imposition.

DISCUSSION

The Department notes that all tax assessments are presumed to be accurate and 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 "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). An exemption from the use tax is granted for transactions when sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4. Since Taxpayer failed to pay sales tax at the time of the purchase, the Department found that the purchases were subject to use tax.

Taxpayer maintains that as a producer or manufacturer of trees, shrubs, and plants it purchases certain items used for production activities, which are exempt under the "manufacturing exemptions" found in IC § 6-2.5-5-3 (the equipment exemption) and IC § 6-2.5-5-5.1 (the consumption exemption).

IC § 6-2.5-5-3(b) provides an exemption from sales 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). Pre-production and post production activities are excluded from the exemption in 45 IAC 2.2-5-8(d), which states 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 § 6-2.5-5-5.1(b) provides an exemption from sales 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... horticulture, floriculture, or arboriculture." In general "[t]he state gross retail tax shall not apply to sales of tangible personal property as a material which is to be directly consumed in direct production by the purchaser in the business of producing... horticultural, floricultural, or arboriculture commodities." 45 IAC 2.2-5-13(a). Property obtained for "direct consumption" is further defined in 45 IAC 2.2-5-13(b) as "materials [that] are directly used in the production process" and have "an immediate effect upon the commodities being produced." Property has "an immediate effect" when it is "an essential and integral part of the integrated process which produces tangible personal property." 45 IAC 2.2-5-13(b).

Accordingly, tangible personal property purchased for the direct use in the direct production of a

manufactured good or for the direct consumption in the direct production of a horticulture, floriculture, or arboriculture good is subject to sales and use tax unless the property used has an immediate effect on and is essential to the production of that marketable good.

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 State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

Taxpayer asserts that it used the supplies and equipment exclusively for tree, shrub, and plant manufacturing purposes and, therefore, the supplies and equipment should be exempt from Indiana sales and use tax. As stated previously, in Indiana, there is not a blanket exemption from sales and use tax for the supplies and equipment that are used exclusively at a "tree nursery." Under Indiana law, the equipment must be directly used or consumed in the direct production of the horticulture, floriculture, or arboriculture products (this is referred to as the "double direct" test). See IC § 6-2.5-5-3(b); 45 IAC 2.2-5-8(c); IC § 6-2.5-5-5.1(b); 45 IAC 2.2-5-13(b). The use of the equipment or the consumption of the supply at the "tree nursery" must directly impact the direct horticulture, floriculture, or arboriculture production processes. Therefore, each piece of equipment and each supply must be evaluated under this "double direct" test.

A. "Exmark Mower."

Taxpayer asserts that the "Exmark mower" (audit report p.10, amount $10,350) is equipment that is directly used in and is an integral part of its tree manufacturing process. Taxpayer uses the mower to mow the grounds in general and to mow around the trees that it has for sale. Taxpayer uses the mower to mow around the trees from the beginning of April to the end of November. Initially, during the audit, Taxpayer provided that the mower was used to maintain the rows to help prevent weeds from growing to provide easier access to the trees and shrubs and to keep the grounds looking clean and professional. During the hearing process, Taxpayer has also stated that it used the mower to keep fungus from growing on the trees and to help prevent fires from spreading. Taxpayer has further claimed that the mower is used to maintain the rows to prevent weeds from growing, which removes a source of insects. Lastly, Taxpayer argues that it would have less marketable trees if it did not mow around them.

Whether the mowing makes a more marketable tree is not relevant. What is determinative is that the maintenance work performed around the trees does not have an immediate effect on the trees themselves, as required by 45 IAC 2.2-5-8(c). While the "Exmark mower" may be a necessary part of Taxpayer's grounds maintenance, no exemption exists for the maintenance of grounds. Since the mower is used to perform necessary but ancillary functions, the mower does not quality for exemption under 45 IAC 2.2-5-8(c).

Therefore, Taxpayer's protest to the imposition of tax on the "Exmark mower" is respectfully denied.

B. "Track Loader."

Taxpayer asserts that the "track loader" (audit report p.7, amount $42,474.35) is equipment that is directly used in and is an integral part of its tree manufacturing. The track loader has various attachments including tree spades, shovels, scoops, grading blades, and forks. Based upon the auditor's observations and Taxpayer's description of how the "track loader" is used, the Department's audit granted Taxpayer a ten percent exemption on the "track loader." This ten percent exemption was based upon Taxpayer's following uses of the equipment: (1) digging out the matured trees and shrubs, which is use in production qualifying as an exempt use, (2) filling holes, which is use in pre-production and post production activities qualifying as a taxable use, and (3) hauling materials such as stone, dirt, debris, and other items, which is use in non-production, pre-production, and post production activities qualifying as taxable uses.

During the hearing, Taxpayer stated that the "track loader" is also used to unload nursery products. However, since unloading the nursery products is use in pre-production and post production activities, Taxpayer has done nothing more than provide another taxable use for the "track loader." Thus, Taxpayer has failed to provide sufficient documentation to substantiate its claim and demonstrate the use of the "track loader" was more than 10 percent exempt.

Therefore, Taxpayer's protest to the imposition of tax on ninety-percent of the "track loader" is respectfully denied.

C. "Gemini Aerator" and "Chemicals for Lake."

Taxpayer asserts that the "Gemini aerator" (audit report p.7, amount $4,974.26) and the "chemicals for lake" (audit report p. 7, amount $725) are supplies and equipment that are directly used in and are an integral part of its plant and tree manufacturing processes. Taxpayer uses the "Gemini aerator" to aerate the water and adds the chemicals to the water to prevent algae from growing on the lake water. Taxpayer maintains that since it uses the lake water to water its trees and plants during dry spells, the "Gemini aerator" and chemicals qualify for the production exemption.

While the "Gemini aerator" and chemicals may be a necessary part of Taxpayer's lake maintenance, the "Gemini aerator" and chemicals are not supplies and machinery having an immediate effect on the plants and trees. The "Gemini aerator" and chemicals simply function to maintain the lake water before it could, potentially, enter into the manufacturing process. Accordingly, the "Gemini aerator" and chemicals are, at best, pre-production activities for a "raw material," and, therefore, do not fall under the exemption.

Therefore, Taxpayer's protests to the imposition of tax on the "Gemini aerator" and to the imposition of tax on the lake chemicals are respectfully denied.

D. Electricity.

Taxpayer asserts that the electricity billed for meter number 106031560 is exempt under the "utility production exemption" found in IC § 6-2.5-5-5.1. Taxpayer states that since its four greenhouses are separately metered to meter number 106031560, the electricity purchased from this meter would be exempt.

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, or arboriculture. This exemption includes transactions involving acquisitions of tangible personal property used in commercial printing as described in IC § 6-2.1-2-4.

The Department refers to 45 IAC 2.2-4-13, provided in relevant part, which clarifies the "utility production exemption," as follows:

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

...

(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[percent]) of the utility services and commodities are consumed for excepted uses.

Accordingly, a taxpayer's utility usage can qualify for a 100 percent exemption under the "utility production exemption" in one of two ways. The taxpayer's utility must be separately metered to the specific pieces of exempt production equipment, or the taxpayer must be able to demonstrate that it predominantly uses the utility in an exempt manor.

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).

Taxpayer asserts that since its four greenhouses are separately metered by meter number 106031560, the electricity purchased from this meter would be exempt. In effect, Taxpayer claims the four greenhouses are the pieces of "production equipment" implying that everything using electricity within the greenhouses would qualify as exempt manufacturing equipment. However, Taxpayer is mistaken. Taxpayer has non-exempt activities taking place within the greenhouses–for example, the post-production storage of mature plants and the pre-production use of pumps that bring chemicals and plant food (raw materials) into the production process. Thus, the electricity used to power these pieces of equipment would not qualify for the exemption, and an analysis considering the actual use of the electric utility would have to be performed. If this analysis demonstrates that the electricity is predominately (more than fifty percent) used for production purposes, Taxpayer could qualify for an exemption for the entire meter. However, if this analysis demonstrates that electricity is used for exempt purposes for a percentage equaling fifty percent or less, Taxpayer would qualify for an exemption for that amount.

In order to demonstrate that it is entitled to an exemption, Taxpayer would first have to provide a breakdown of all the equipment that was powered from meter number 106031560. Then, Taxpayer would also have to provide an evaluation of the use of each piece of that equipment and whether the use qualifies as an exempt use of equipment that is directly involved in the direct production process or a non-exempt use of the equipment this is used in pre-production, post-production, or non-production processes or activities. Taxpayer, however, did not demonstrate or document the specific equipment that is powered by the electricity from meter number 106031560 and the ways in which Taxpayer uses that equipment to support its claimed exemption. Since Taxpayer has failed to provide sufficient documentation to demonstrate that Taxpayer's electricity usage qualifies for an exemption, Taxpayer has failed to meet its burden of proof under IC § 6-8.1-5-1(c).

Therefore, Taxpayer's protest to the imposition of tax on its electricity from meter number 106031560 is denied.

E. Diesel.

While the Department's audit granted a five percent exemption on Taxpayer's diesel purchases, Taxpayer, to the contrary, claims it is entitled to a 90 percent exemption.

During the hearing, Taxpayer asserted that the diesel is used in fifteen pieces of exempt equipment. Taxpayer stated that it would provide further information, such as an equipment list detailing these fifteen pieces of equipment, the exempt and non-exempt uses of that equipment, and how much of diesel each piece of equipment used. However, Taxpayer did not provide this information. Taxpayer has failed to provide sufficient documentation to substantiate its claim and demonstrate the use of the diesel added to anything other than the five percent exemption.

Therefore, Taxpayer's protest to the imposition of tax on its diesel purchases is respectfully denied.

F. "Gore Tex Bibs, Parkas, and Pants."

Taxpayer asserts that the "Gore Tex bibs, parkas, and pants" (audit report p.7, amount $3,098.60) are supplies and equipment that are directly used in and are an integral part of its plant and tree manufacturing processes.

Taxpayer protests the assessment of tax on the "Gore Tex bibs, parkas, and pants" worn while it is cold and rainy and while employees are spraying chemicals. Taxpayer contends that the "Gore Tex bibs, parkas, and pants" are provided for employee safety. While the "Gore Tex bibs, parkas, and pants" are provided for the convenience and necessity of its employees during inclement weather conditions, they do not qualify for exemption. Since the "Gore Tex bibs, parkas, and pants" are neither used to prevent employees from being injured by the production process nor to prevent contamination of the product being produced, the "Gore Tex bibs, parkas, and pants" are taxable under 45 IAC 2.2-5-8(c).

Therefore, Taxpayer's protest to the imposition of tax on the "Gore Tex bibs, parkas, and pants" is respectfully denied.

G. "Repair Equipment."

Taxpayer asserts that the Department has assessed tax on "repair equipment" for which it is entitled to an exemption. Taxpayer did not demonstrate or document an exempt use of the "repair equipment." Additionally, during the hearing, Taxpayer stated that it would provide a list of the "repair equipment" and specific details of use for each type of equipment for which it was asserting an exempt use. However, Taxpayer did not provide a list of "repair equipment" or any further details.

Nonetheless, 45 IAC 2.2-5-8(h)(1) states, "Machinery, 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." Thus, repair equipment is subject to tax.

Therefore, Taxpayer's protest to the imposition of tax on "repair equipment" is respectfully denied.

H. "Chainsaw Repair."

Taxpayer asserts that it made purchases for "chainsaw repair" (audit report p.14, amounts $48.25, $45.01, $83.26, $12.25, and $77.77), including "bar oil," an "HD Bar," a "chisel chain," and a "saw chain," a "spark plug," and "throttle return," which are exempt.

Pursuant to 45 IAC 2.2-5-8(h)(2) "[r]eplacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax." Accordingly, parts purchased for the chainsaw would be tax exempt to the extent that the chainsaw is exempt.

Taxpayer asserts that the chainsaw is equipment that is directly used in and is an integral part of its tree manufacturing because Taxpayer uses the chainsaw to clear the fields to get them ready for the planting of the new trees. However, using the chainsaw to clear the field to plant trees is part of general maintenance of Taxpayer's grounds. While the chainsaw may be a necessary part of Taxpayer's grounds maintenance, no exemption exists for the maintenance of grounds. Since the chainsaw is used to perform necessary but ancillary functions, neither the chainsaw nor the repair parts for the chainsaw quality for exemption under 45 IAC 2.2-5-8(c).

Therefore, Taxpayer's protest to the imposition of tax on "chainsaw repair" is respectfully denied.

I. "U Cup Seals."

Taxpayer asserts that it purchased "U cup seals" (audit report p. 14, $42.00) as repair parts for its "Green Hoe equipment," and as such the "U cup seals" are exempt.

Pursuant to 45 IAC 2.2-5-8(h)(2) "[r]eplacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax." Accordingly, parts purchased for the "Green Hoe equipment" would be tax exempt to the extent that the "Green Hoe equipment" is exempt.

Taxpayer did not demonstrate or document an exempt use of the "Green Hoe equipment." During the hearing, Taxpayer stated that it would provide additional information and specific details of the uses of the "Green Hoe equipment." However, Taxpayer did not provide any additional information. Since Taxpayer failed to demonstrate the exempt status of the "Green Hoe equipment," Taxpayer has failed to meet its burden of proof under IC § 6-8.1-5-1(c).

Therefore, Taxpayer's protest to the imposition of tax on the "U cup seals" is respectfully denied.

FINDING

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

II. Tax Administration – Penalty.

DISCUSSION

The Taxpayer also protested 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:
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> 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:
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> (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.

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 provided sufficient information for the Department to agree that Taxpayer's failure to pay the deficiency was due to reasonable cause as required by 45 IAC 15-11-2(c). While Taxpayer's current circumstances show that Taxpayer acted with reasonable cause, Taxpayer is on notice that penalty waiver might not be warranted should these circumstances arise again in the future.

FINDING

Taxpayer's protest to the imposition of penalty is sustained.

CONCLUSION

Taxpayer's protest to the imposition of use tax, as discussed in Issue I, is respectfully denied. Taxpayer's protest to the imposition of penalty, as discussed in Issue II, is sustained.

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