

Letter of Findings Number: 09-0808
Use Tax
For Tax Years 2006-08

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ISSUES

I. Use Tax—Manufacturing Exemption.

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

Taxpayer protests the imposition of use tax on its purchase of several pieces of equipment which it believes qualify 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 a manufacturer in Indiana. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had not paid sales tax on its purchases of several items upon which sales tax should have been paid. The Department therefore issued proposed assessments for use tax, ten percent negligence penalties, and interest for the tax years 2006, 2007, and until late January 2008, when Taxpayer was sold to another entity. Taxpayer protested the assessment of a portion of the use tax and of all of the penalties. Taxpayer states that some of the purchases in question were for manufacturing equipment and were therefore exempt from sales tax. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Use Tax—Manufacturing Exemption.

DISCUSSION

Taxpayer protests a portion of the proposed assessments for use tax for the tax years 2006, 2007, and through late January 2008. Taxpayer states that some of the items purchased were eligible for the manufacturing exemption and that sales and use tax should not be imposed on those purchases. Specifically, Taxpayer states that its raw material sequencing equipment and automated shuttle machinery are exempt production machinery, and that its returnable containers are partially exempt. 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).

Taxpayer provided an explanation of its production process. Taxpayer has a single customer for its goods. Taxpayer's customer places orders for specific products to match its own concurrently-produced product, at which point Taxpayer removes the appropriate parts from storage and puts those parts into its raw materials sequencing system. Taxpayer then assembles those parts into its product. Taxpayer's customer also requires Taxpayer to put those products into matched sets and those matched sets into specific order for direct insertion into the customer's production line. Therefore, Taxpayer argues that the production process begins at the point it pulls parts out of storage and places them into the raw material sequencing system for assembly into the specific components its customer orders, and ends with the loading of matched sets onto the transport vehicles, in the specific sequence ordered by its customer.

The sales tax is imposed by 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.

The use tax is imposed under IC § 6-2.5-3-2(a), which states:

- (a) 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.

Also, [45 IAC 2.2-3-4](#) provides:

Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

Therefore, when tangible personal property is acquired in a retail transaction and is stored, used, or consumed in Indiana, Indiana use tax is due if sales tax has not been paid at the point of purchase. In this case,

the Department determined that Taxpayer had acquired tangible personal property in retail transactions and used that property in Indiana without paying sales tax at the point of purchase. The Department therefore issued proposed assessments for use tax, as provided by [45 IAC 2.2-3-4](#).

Taxpayer states that some of the tangible personal property at issue was used in its manufacturing process and was therefore not subject to sales or use tax. The manufacturing exemption is found at IC § 6-2.5-5-3, which 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).

As provided under IC § 6-2.5-5-3(b), items must meet the "double direct" test in order to qualify for exemption. Taxpayer believes that the items under protest meet this standard and qualify for the exemption.

The Indiana Tax Court has addressed the question of what constitutes a manufacturing operation. In *General Motors Corp. v. Indiana Dep't of State Revenue*, 578 N.E.2d 399, 401 (Ind. Tax Ct. 1991), the Court provided:

The double direct standard, expressed in the statutory language emphasized above, is the touchstone of the equipment exemption from sales/use tax. In *Indiana Department of State Revenue v. Cave Stone, Inc.* (1983), Inc., 457 N.E.2d 520, the seminal case interpreting the double direct standard, the Indiana Supreme Court recognized the essential and integral test to determine whether the double direct standard is met. The court held the transportation equipment at issue was both essential to transforming crude stone into a marketable product and integral to "the ongoing process of transformation." Id. at 524.

The court's inquiry focused on the production process itself, defining it broadly to encompass all the production steps involved in transforming work in process into a finished marketable product:

The [equipment exemption] statute circumscribes all of the operations or processes by which the finished product is derived. **Thus, we find that the production or processing of the stone begins at the time of the initial stripping, drilling, and blasting at the quarry and ends at the time the stone is stockpiled. The production process is continuous and indivisible.**

(Emphasis added).

The Court further provided:

The Department erroneously draws an artificial and arbitrary boundary based on the first marketable product to emerge rather than drawing the more logical line based on the actual end product produced. Under an approach focusing on the actual end product marketed, GM's packing materials used to transport component parts sold to non-GM manufacturers and those used to transport finished replacement parts would still be taxed. On the other hand, packing materials used to transport work in process parts from GM's component plants to GM's assembly plants would be exempt as an essential and integral part of GM's integrated production process of manufacturing finished automobiles. Finally, a determination that an integrated production process ends upon the completion of the actual end product marketed (the most marketable product) is wholly consistent with the legislative purposes of the exemption statutes to encourage industrial growth and to avoid tax pyramiding.

Id. at 405.

(Emphasis added).

In that case, General Motors had several component plants which made components which were assembled at another General Motors plant. The Court determined that General Motors' integrated production process began at the various General Motors component plants and ended upon the completion of the actual end product marketed, which in General Motors' case was a finished vehicle, at another General Motors plant.

In the audit report, the Department determined that Taxpayer's production process began after the raw material sequencing and ended with the manufacture of a single component. Taxpayer protests that its raw materials sequencing equipment is exempt and refers to [45 IAC 2.2-5-8](#), which provides in relevant parts:

(a) In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.

(b) The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property.

(c) The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. 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.

–EXAMPLES–

(1) Aluminum pistons are produced in a manufacturing process that begins, after the removal of raw aluminum from storage inside the plant, with the melting of the raw aluminum and the production of castings in the foundry; continues with the machining of the casting and the plating and surface treatment of the piston; and ends prior to the transportation of the completed pistons to a storage area for subsequent shipment to customers. Because of the functional interrelationship of the various steps and the flow of the work-in-process, the total production process, comprised of such activities, is integrated.

(2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product, is not determinative.

...

(G) An automated scale process which measures quantities of raw aluminum for use in the next production step of the casting process in the foundry.

...

(4) Because of the lack of an essential and integral relationship with the integrated production system in Example (1), the following types of equipment are not exempt:

...

(G) Equipment used to remove raw materials from storage prior to introduction into the production process or to move finished products from the last step of production.

...

(g) "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.

–EXAMPLES–

(1) The manufacturing equipment utilized for the production of plastics consists of an interconnected system which contains among its components a coal fueled boiler, heat exchangers, vacuum jets, process heating vessels, distillation/stripping columns, related equipment, and piping. All elements of this integrated production process are exempt from tax.

...

(j) Managerial, sales, and other non-operational activities. Machinery, tools, and equipment used in managerial sales, research, and development, or other non-operational activities, are not directly used in manufacturing and, therefore, are subject to tax. This category includes, but is not limited to, tangible personal property used in any of the following activities: management and administration; selling and marketing; exhibition of manufactured or processed products; safety or fire prevention equipment which does not have an immediate effect on the product; space heating; ventilation and cooling for general temperature control; illumination; heating equipment for general temperature control; and shipping and loading.

(k) "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.

....

(Emphasis added).

Taxpayer refers to [45 IAC 2.2-5-8\(c\)](#) example (2)(G) in support of its protest. Taxpayer states that its raw materials sequencing system serves the same function as an automated scale process which measures quantities of raw aluminum for use in the next production step of the casting process in the foundry, as found in that example. Taxpayer believes that the raw materials sequencing system therefore qualifies as exempt.

The Department does not agree that the raw materials sequencing system qualifies for this exemption. That system does not measure or weigh the parts placed into it, as discussed in [45 IAC 2.2-5-8\(c\)](#) example (2)(G).

Rather, the system is similar to the non-exempt equipment used to remove raw materials from storage prior to introduction into the production process discussed in [45 IAC 2.2-5-8\(c\)](#) example (4)(G). Until Taxpayer takes the first step to assemble its product, the various components and the equipment used to move or store the parts are at the pre-production stage and are therefore not exempt production equipment.

Taxpayer also protests the imposition of use tax on its purchase of equipment used in an automated shuttle system and argues that its actual end product is the matched components in the sequence its customer demands. Taxpayer states that its customer will not accept a randomized load of Taxpayer's components and that those components must be matched into sets and loaded in its customer's specified sequence. Taxpayer therefore believes that the manufacturing process ends with the loading of matched sets of components onto transport vehicles, which is performed by and with the automated shuttle equipment. Taxpayer has provided documentation in support of this position.

After review of this documentation, it is clear that while Taxpayer's customer requires Taxpayer to ship its products in a specific sequence, that shipping sequence is not an integral part of an integrated process which produces tangible personal property. Taxpayer manufactures its components and then attaches them to shipping devices, thereby arranging Taxpayer's components into matched sets for direct insertion into Taxpayer's customer's production line. This matching and sequencing constitutes a service Taxpayer provides to its customer. It does not constitute production.

The fact that Taxpayer's customer will not accept the components if they are not matched and in order is not determinative. Rather, the standard is the double direct test, as provided by IC § 6-2.5-5-3(b) and discussed in General Motors. "Direct production" is further defined by [45 IAC 2.2-5-8\(k\)](#), which provides that 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. The only substantial changes in the materials occur when Taxpayer assembles the parts it purchases into its product, which it then sells to its customer. The end product is the component. The matching and sequencing of components does not change the form, composition, or character of the tangible personal property.

The Department notes that Taxpayer is not a subsidiary of its customer nor is it in any way related to its customer. In General Motors, the court explained that if General Motors sold the components to non-General Motors manufacturers, the end product would be the components and the shipping materials would be taxable. In General Motors, all production plants were owned by General Motors. In the instant case, Taxpayer's actual marketed end product is the components which it sells to its customer. Taxpayer's customer uses those components to continue its own production process. As provided in General Motors, under an approach focusing on the actual marketed end product, Taxpayer's automated shuttle equipment is used to load the actual marketed end product which is sold to its customer. That equipment is used in a post-production activity and is properly subject to tax.

Taxpayer also protests that its returnable shipping containers are partially exempt. Taxpayer states that the containers are an integral part of an integrated production process by virtue of the fact that the containers are used twenty-five percent of the time to move raw materials from storage to the production process. Taxpayer believes that this constitutes use of the containers to move work-in-process, as provided by [45 IAC 2.2-5-8\(f\)](#), which provides in relevant part:

- (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.

....

(Emphasis added).

Taxpayer argues that the containers are moving work-in-process and are therefore exempt as provided by [45 IAC 2.2-5-8\(f\)\(3\)](#). As previously discussed, merely gathering the parts which Taxpayer purchases from its suppliers does not constitute production. [45 IAC 2.2-5-8\(f\)\(1\)](#) is the appropriate reference here. The containers are used to move the raw materials prior to their introduction into the production process. Taxpayer performs no work upon the parts moved in the containers. The fact that the production process has commenced prior to the introduction of the parts in the containers is not determinative. Once the parts are removed, Taxpayer puts nothing back into the containers. The containers do not move work-in-process. The containers only move raw materials to the production process and are taxable as provided by [45 IAC 2.2-5-8\(f\)\(1\)](#).

In conclusion, the raw materials sequencing equipment is not part of the production process. That equipment does not alter or measure or weigh the raw materials. It has no effect on the raw materials. The automated shuttle machinery which matches and sequences Taxpayer's products is post-production equipment and is properly

taxable. It has no effect on the finished product. The fact that Taxpayer's customer demands matched and sequenced components does not change the fact that the matching and sequencing does not alter the component. The end product is Taxpayer's component. The returnable containers are used to move raw materials and not work-in-process. The returnable containers are therefore properly taxable. Taxpayer has not met the burden of proving the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is denied.

II. Tax Administration–Negligence Penalty.

DISCUSSION

The Department issued a proposed assessment and the ten percent negligence penalty for the tax years in question. Taxpayer protests the imposition of penalty and states that the equipment discussed in Issue I was used at least for some exempt purposes. 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.

(Emphasis added).

[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 an assessment 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 states that it acted reasonably and that it had a reasonable basis for believing that the items discussed in Issue I above were exempt from sales and use tax. After review of the circumstances in this case, Taxpayer has established that the assessment arose due to reasonable cause and not due to negligence, as required by [45 IAC 15-11-2](#)(c).

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer is denied on Issue I regarding the imposition of use tax. Taxpayer is sustained on Issue II regarding imposition of penalty.

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