

Letter of Findings Number: 09-1045
Use Tax
For Tax Years 2007-08

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 It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register.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. Use Tax—Mining Exemption.

Authority: 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](#); [45 IAC 2.2-5-9](#); IC § 6-1.1-1-11.

Taxpayer protests the imposition of use tax on several items which it believes are exempt.

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 corporation in the mining business. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had not paid sales tax at the time it purchased several items of tangible personal property during the tax years 2007 and 2008. The Department therefore issued proposed assessments for use tax, ten percent negligence penalties, and interest for those years. Taxpayer protests that several items listed as taxable were actually exempt from sales and use taxes. In the course of the protest process, Taxpayer provided information and explanation to the auditor, who agreed to remove some of the items included as taxable in the audit report. The auditor did not agree to all of the protested items. Taxpayer therefore protests the imposition of use tax and ten percent negligence penalties. An administrative hearing was conducted and this Letter of Findings results, incorporating those items which the auditor previously agreed to remove from the calculations of taxable purchases. Further facts will be supplied as required.

I. Use Tax—Mining Exemption.

DISCUSSION

Taxpayer protests the imposition of use tax on several items it purchased in the tax years 2007 and 2008. The Department had determined that these items and others were non-exempt and included them in its calculation of taxable items for those years. Taxpayer states that several foundations and electrical supply systems used in its mining and processing facility were used in conjunction with exempt machinery and are therefore exempt as well. Also, Taxpayer protests that several items were constructed under lump sum contracts in which the contractor paid sales tax when it purchased the tangible personal property ("TPP") used in the construction. Therefore, Taxpayer argues that it would not be subject to sales or use tax on those contracts. 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 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 protests that several of the items included in the Department's calculations of taxable purchases are actually exempt from sales and use taxes. The first category of items includes foundations for pieces of equipment which Taxpayer states are exempt production machinery. Taxpayer states that, since the equipment

which is supported by the foundations are exempt, the foundations themselves are exempt.

The relevant statute is 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).

The exemption is further defined by [45 IAC 2.2-5-9](#), which states in relevant part:

(a) In general, all purchases of tangible personal property by persons engaged in extraction or mining are taxable. The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to manufacturing machinery, tools, and equipment directly used in mining or extraction. It does not apply to materials consumed in mining or extraction.

(b) The state gross retail tax shall not apply to sales of manufacturing machinery, tools, and equipment which are to be directly used by the purchaser in extraction or mining.

(c) Manufacturing machinery, tools, and equipment to be directly used by the purchaser in the extraction or mining process are exempt from tax provided that such machinery, tools and equipment are directly used in the production process; i.e., they have an immediate effect on the item being produced by mining or extraction. 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) Crushed stone is produced in a mining, production, and processing operation that begins with stripping overburden from an area to be mined, continues with the extraction and crushing of the stone, and ends with the stockpiling of the stone, which allows moisture to drain and evaporate from the washed stone, thereby reducing moisture levels to a standard more generally acceptable to stone purchasers. Because of the functional interrelationship of the various steps and the flow of the work-in-process, the total process comprised by these activities is integrated.

(2) Coal is produced in a surface mining operation that begins with the clearing of surface obstacles and overburden from the land above the coal deposit to be mined, continues with the removal of waste material and with the extraction of the coal, continues further with the transportation from the coal seam to the processing facility, continues further with the refilling and grading of the mined area with overburden and waste material from a subsequently mined area, continues further with the cleaning of the coal, and ends with the stockpiling of the coal to allow moisture to drain and evaporate from the washed coal, thereby reducing moisture levels to a standard more generally acceptable to coal purchasers. Because of the functional interrelationship of the various steps and the flow of the work-in-process, the total process comprised of such activities is integrated. The following items are exempt:

(A) Equipment used to modify the energy purchased for the surface mining process if the equipment is used to modify the energy for use by exempt equipment;

(B) Pumps and hose used to remove water or to divert water from the active pit area;

(3) "Coal is produced in an underground mining operation that begins with the boring of a shaft from the surface to the coal deposit to be mined, continues with the removal of waste material and the extraction of coal, continues further with transportation from the coal seam to the processing facility, continues further with the installation of roof supports and the coating of walls with rock dust to prevent mine explosion and collapse, continues further with cleaning of coal, and ends with the stockpiling of coal to allow moisture to drain and evaporate from the washed coal, thereby reducing moisture levels to a standard more generally acceptable to coal purchasers. Because of the functional interrelationship of the various steps and the flow of the work in process, the total process comprised of such activities is integrated." The following are exempt:

...

(C) The feeder breaker which breaks the large lumps of coal and feeds the coal onto the conveyor belt which carries the coal outside the mine where it is stockpiled or transported to the processing facility.

(D) Electrical cable supplying electricity to exempt production equipment in the underground mine as part of an electrical distribution system.

(E) Equipment used to modify the energy purchased for the underground mining process if the equipment is used to modify the energy for use by exempt equipment.

(F) Pumps and hose used to remove water from the underground mine.

(4) 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.

...

(C) Electrical cable supplying electricity to exempt production equipment in the field as part of an electrical distribution system.

...

(E) Equipment used in a coal wash plant to clean the coal prior to sale to customers.

(F) Equipment used to blend different grades of coal together so that the final product meets customer specifications regarding quality and sulfur content.

...

(e) Equipment directly used in extraction or mining: Manufacturing machinery, tools, and equipment used directly in the mining or extraction process are taxable unless the machinery, tools, and equipment have an immediate effect upon mining or extracting the product. The fact that particular property may be considered essential to the conduct of the business of mining because its use is required either by law or practical necessity does not, of itself, mean that the property has an immediate effect upon the mining or extracting of the product. Instead, in addition to being essential for one of the above reason [sic.], the property must also be an integral part of an integrated process.

....

(Emphasis added).

Also of relevance is the [45 IAC 2.2-5-8](#), which addresses the general manufacturing equipment exemption and states in relevant part:

...

(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–

...

(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.

...

(E) A work bench used in conjunction with a work station or which supports production machinery within the production process.

...

(Emphasis added).

Also, property tax statute IC § 6-1.1-1-11 states:

(a) Subject to the limitation contained in subsection (b), "personal property" means:

(1) billboards and other advertising devices which are located on real property that is not owned by the owner of the devices;

(2) foundations (other than foundations which support a building or structure) on which machinery or equipment:

(A) held for sale in the ordinary course of a trade or business;

(B) held, used, or consumed in connection with the production of income; or

(C) held as an investment;

is installed;

(3) all other tangible property (other than real property) which:

(A) is being held as an investment; or

(B) is depreciable personal property; and

(4) mobile homes that do not qualify as real property and are not described in subdivision (3).

(b) Personal property does not include the following:

(1) Commercially planted and growing crops while in the ground.

(2) Computer application software.

(3) Inventory. (Emphasis added).

Since a work bench used in conjunction with a work station or which supports production machinery within the production process is exempt equipment for sales and use tax purposes and, since sales and use taxes only apply to the transfer of tangible personal property, it stands to reason that such a work bench is tangible personal property. The foundations in question in this protest are analogous to the work bench discussed in [45 IAC 2.2-5-8\(c\)](#) example (2)(E), as supported by IC § 6-1.1-1-11(a)(2)(B). While ordinary building foundations are clearly not eligible for the manufacturing exemption, the foundations at issue here support equipment which is either

production machinery or which moves materials within the production process. As provided by IC § 6-2.5-5-3 and [45 IAC 2.2-5-9](#), that equipment is exempt. Therefore, the foundations at issue qualify for the manufacturing exemption as provided by [45 IAC 2.2-5-8\(c\)](#) example (2)(E).

Taxpayer also protests the imposition of sales tax on electrical power systems and various other construction projects at its production site. As provided above, electrical power systems which supply power to exempt machinery are themselves exempt from sales and use taxes. Regarding the other construction projects, Taxpayer states that the construction was performed under lump sum contracts and that the contractor paid sales tax on the tangible personal property at the time it purchased the TPP.

The relevant regulation is [45 IAC 2.2-4-20](#), which states:

- (a) A contractor may purchase construction material exempt from the state gross retail tax only if he issues either an exemption certificate or a direct pay certificate to the seller at the time of purchase.
- (b) A contractor, who purchases construction material exempt from the state gross retail tax or otherwise acquires construction material "tax-free", is accountable to the Department of Revenue for the state gross retail tax when he disposes of such property unless the ultimate recipient could have purchased it exempt (see 6-2.5-5 [[45 IAC 2.2-5](#)]).
- (c) A contractor has the burden of proof to establish exempt sale or use when construction material, which was acquired "tax-free", is not subject to either the state gross retail tax or use tax upon disposition.
- (d) Disposition subject to the state gross retail tax. A contractor-retail merchant has the responsibility to collect the state gross retail tax and to remit such tax to the Department of Revenue whenever he disposes of any construction material in the following manner:
 - (1) Time and material contract. He converts the construction material into realty on land he does not own and states separately the cost for the construction materials and the cost for the labor and other charges (only the gross proceeds from the sale of the construction material are subject to tax); or
 - (2) Construction material sold over-the-counter. Over the counter sales of construction materials will be treated as exempt from the state gross retail tax only if the contractor receives a valid exemption certificate issued by the person for whom the construction is being performed or by the customer who purchases over-the-counter, or a direct pay permit issued by the customer who purchases over-the-counter.
- (e) Disposition subject to the use tax. With respect to construction material a contractor acquired tax-free, the contractor is liable for the use tax and must remit such tax (measured on the purchase price) to the Department of Revenue when he disposes of such property in the following manner:
 - (1) He converts the construction material into realty on land he owns and then sells the improved real estate;
 - (2) He utilizes the construction material for his own benefit; or
 - (3) Lump sum contract. He converts the construction material into realty on land he does not own pursuant to a contract that includes all elements of cost in the total contract price.

A disposition under C. [subsection (e)(3) of this section] will be exempt from the use tax if the contractor received a valid exemption certificate from the ultimate purchaser (purchaser) or recipient of the construction material (as converted), provided such person could have initially purchased such property exempt from the state gross retail tax.

Therefore, sales tax is due from a contractor's customer when a contractor purchases materials without paying sales tax at the time of purchase and converts those materials into realty on land it does not own and when the cost for the construction materials is stated separately from the cost for the labor and other charges, as provided by [45 IAC 2.2-4-20\(d\)\(1\)](#). This provision is based on the presumption that the contractor did not pay sales tax at the time it purchased the materials. Here, the Department originally determined that the construction projects, the construction of which converted materials into realty on land not owned by the contractor, were performed via time and materials contracts and that the contractor did not collect sales tax on the sale of the materials. Taxpayer has since provided sufficient documentation to establish that the contractor paid sales tax on the materials at the time it purchased them in the course of completing a lump sum contract. Since the contractor paid sales tax at the time of purchase, the contractor had no duty to collect sales tax from Taxpayer since those materials were incorporated into Taxpayer's realty under a lump sum contract.

In conclusion, the foundations in question support exempt production machinery and equipment. The foundations are therefore exempt. The electrical systems supply power to exempt production machinery and equipment and are therefore exempt. Taxpayer provided sufficient documentation to establish that the contractor in question paid sales tax at the point it purchased the materials. The contractor therefore had no duty to collect sales tax upon completion of the lump sum contract construction projects.

FINDING

Taxpayer's protest is sustained.

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 it acted reasonably in its sales and use tax

duties. 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 been sustained on the items protested in Issue I above. However, there remain several items which were not protested and which were clearly not eligible for the mining exemption. Taxpayer has not established that the assessment of use tax on these remaining items arose due to reasonable cause and not due to negligence, as required by [45 IAC 15-11-2\(c\)](#).

FINDING

Taxpayer's protest is denied.

CONCLUSION

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

Posted: 11/24/2010 by Legislative Services Agency

An [html](#) version of this document.