DEPARTMENT OF STATE REVENUE

04-20100142.LOF

Letter of Findings: 10-0142
Sales and Use Tax
For the Years 2006, 2007, and 2008

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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 § 6-2.5-5-2; IC § 6-2.5-5-3; IC § 6-2.5-5-5.1; IC § 6-2.5-5-30; IC § 6-8.1-5-1; 45 IAC 2.2-5-1; 45 IAC 2.2-5-6; 45 IAC 2.2-5-8; 45 IAC 2.2-5-11; 45 IAC 2.2-5-12; 45 IAC 2.2-5-70; 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); Mechanics Laundry & Supply, Inc. v. Indiana Dep't of State Revenue, 650 N.E.2d 1223 (Ind. Tax Ct. 1995); Indianapolis Fruit Co. v. Indiana Dep't of State Revenue, 691 N.E.2d 1379 (Ind. Tax Ct. 1998); White River Envtl. P'ship v. Indiana Dep't of State Revenue, 694 N.E.2d 1248 (Ind. Tax Ct. 1998); Mumma Bros. Drilling Co. v. Indiana Dep't of State Revenue, 411 N.E.2d 676 (Ind. Ct. App. 1980).

Taxpayer protests the assessment of tax on its 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 in the business of hauling sludge. Taxpayer is paid to haul away what is left from the waste water treatment plants at various cities (human waste) and manufacturing facilities.

The Indiana Department of Revenue ("Department") conducted a sales and use tax audit for tax years 2006, 2007, and 2008. Both Taxpayer and the Department agreed to utilize a statistical sample drawn from the 2008 tax year and projected to 2006 and 2007 to determine Taxpayer's liabilities for those years.

Pursuant to the audit, the Indiana Department of Revenue ("Department") determined that Taxpayer made several purchases without paying sales tax at the time of the retail transactions or self-assessing and remitting to the Department the use tax. As a result, the Department's audit assessed Taxpayer additional use tax, interest, and penalty.

Taxpayer timely protests the assessment and submitted additional documentation to support its protest. 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 its purchases of tangible personal property because Taxpayer did not pay sales tax at the time of the transactions, nor did it self-asses *[sic]* and remit the use tax to the Department accordingly. Taxpayer, to the contrary, claimed that it is entitled to agricultural and manufacturing 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, extraction, harvesting, or processing of agricultural commodities are taxable. 45 IAC 2.2-5-6(a). 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).

IC § 6-2.5-5-2 states:

(a) Transactions involving agricultural machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for his **direct use in the direct production**, extraction, harvesting, or processing **of agricultural commodities**.

(b) Transactions involving agricultural machinery or equipment are exempt from the state gross retail tax if:

(1) the person acquiring the property acquires it for use in conjunction with the production of food and food ingredients or commodities for sale;

(2) the person acquiring the property is occupationally engaged in the production of food or commodities which he sells for human or animal consumption or uses for further food and food ingredients or commodity production; and

(3) the machinery or equipment is designed for use in gathering, moving, or spreading animal waste. (**Emphasis added**).

45 IAC 2.2-5-1(a) further provides:

Definitions. "Farmers" means only those persons **occupationally engaged in producing food or agricultural commodities for sale or for further use in producing food or such commodities for sale**. These terms are limited to those persons, partnerships, or corporations regularly engaged in the commercial production for sale of vegetables, fruits, crops, livestock, poultry, and other food or agricultural products. Only those persons, partnerships, or corporations whose intention it is to produce such food or commodities at a profit and not those persons who intend to engage in such production for pleasure or as a hobby qualify within this definition.

"Farming" means engaging in the commercial production of food or agricultural commodities as a farmer. **"To be directly used by the farmer in the direct production of food or agricultural commodities" requires that the property in question must 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 food or an agricultural commodity**. (**Emphasis added**).

Additionally, 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. (**Emphasis added**).

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. (**Emphasis added**).

The exemption for direct use in production is explained at 45 IAC 2.2-5-11 and the exemption for direct consumption in production is further explained at 45 IAC 2.2-5-12.

Moreover, IC § 6-2.5-5-30 provides:

Sales of tangible personal property are exempt from the state gross retail tax if:

(1) the property constitutes, is incorporated into, or is consumed in the operation of, a device, facility, or structure **predominantly used and acquired for the purpose of complying with any state, local, or federal environmental quality statutes, regulations, or standards; and**

(2) the person acquiring the property is engaged in the business of manufacturing, processing, refining, mining, or agriculture.

The portion of the sales price of tangible personal property which is exempt from state gross retail and use taxes under this section equals the product of: (A) the total sales price; multiplied by (B) one hundred percent (100[percent]). (**Emphasis added**).

45 IAC 2.2-5-70(a), in relevant part, further states:

The state gross retail tax does not apply to sales of tangible personal property which constitutes, is incorporated into, or is consumed in the operation of, a device, facility, or structure **predominately used and acquired for the purpose of complying with any state, local or federal environmental qaulity [sic] statutes, regulations or standards**; **and the person acquiring the property is engaged in the business of manufacturing, processing, refining, mining, or agriculture**. (**Emphasis added**).

Accordingly, only when a taxpayer demonstrates that it engages in "production" and it "directly used (or consumed)" the tangible personal property in its "direct production" process, the above mentioned statutory exemptions are applicable.

In Indianapolis Fruit Co. v. Indiana Dep't of State Revenue, 691 N.E.2d 1379 (Ind. Tax Ct. 1998), the taxpayer, Indianapolis Fruit Co., claimed that it was entitled to agricultural and manufacturing exemptions for the tangible personal property it had purchased for ripening bananas and tomatoes. The Tax Court stated that:

In the context of the exemption provisions at issue, **production is "defined broadly" and "focuses on the creation of a marketable good."** The exemption provisions were enacted to deal with a host of different activities and factual situations. As a result, mathematical precision in the application of these exemptions cannot be expected, and any evaluation of whether production is occurring depends on the factual circumstances of the case. However, there is one iron-clad rule: without production there can be no exemption. Id. at 1383-84. (internal citation and quotation marks omitted) (**Emphasis added**).

The Court, in Indianapolis Fruit, found that the bananas had undergone substantial change and had transformed from "green, hard, inedible, and unmarketable bananas" to "yellow, edible, and sellable bananas" after the bananas were placed in air and temperature controlled banana ripening booths and the taxpayer applied

ethylene gas to the bananas. Id. at 1385. The Court, however, declined to find the same result for the taxpayer's tomatoes. The Court determined that "production" occurred as the taxpayer created the sellable bananas, but the taxpayer did not actively perform the same or similar activities to produce the sellable tomatoes. As a result, the Court, in Indiana Fruit, concluded that the taxpayer was entitled to the exemptions for its purchases of tangible personal property to be used or consumed in the bananas' production process, but not the tomatoes' production process.

Similarly, in White River Envtl. P'ship v. Indiana Dep't of State Revenue, 694 N.E.2d 1248 (Ind. Tax Ct. 1998), the taxpayer, White River Environmental Partnership (WREP), which operated a wastewater treatment facility, claimed that it was entitled to statutory exemptions for the equipment which it purchased to be used in its wastewater treatment process. The Indiana Tax Court first followed the well-established case law stating that a taxpayer must "engage in production before receiving an exemption." Id. at 1250.

The Tax Court in White River explains:

> In [Mechanics Laundry & Supply, Inc. v. Indiana Dep't of State Revenue, 650 N.E.2d 1223 (Ind. Tax Ct. 1995)], **the terms listed in the exemption provisions, i.e., processing, manufacturing, etc., have meaning only to the extent that there is production. If there is no production of goods, the exemption provisions at issue do not apply**. Therefore, WREP's entitlement to a sales and use tax exemption rests not on whether wastewater treatment can be called processing, but rather whether WREP is engaged in the production of goods.
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> [T]he fact that WREP substantially changes the wastewater does not ispo *[sic]* facto lead to the conclusion that production for purposes of the exemption provisions is taking place. **Production, within the context of the exemption provisions at issue, is "defined broadly" and "focuses on the creation of a marketable good." In this case, the "products" of the wastewater treatment process (clean water, ash, and sludge) are not sold to others.** The clean water is discharged into the White River, and the ash and sludge are disposed of in a landfill. Id. at 1250-51. (internal citation and quotation marks omitted) (**Emphasis added**).

The Tax Court, in White River, further referred to Mumma Bros. Drilling Co. v. Indiana Dep't of State Revenue, 411 N.E.2d 676 (Ind. Ct. App. 1980), where the Indiana Court of Appeals determined that the taxpayer, who drilled water wells and installed pumps and plumbing for residences, farms, and commercial entities in order to provide water for animal and human consumption, was not entitled to exemptions because the taxpayer did not produce a marketable good. Following the same analysis in Mumma Bros., the Tax Court in White River illustrated:

> The legislature enacted the sales and use tax exemption in order to prevent tax pyramiding, i.e., a situation where a tax is levied upon a tax. In Mumma Bros., a situation where the "**product**," i.e., the extracted water, **was not resold**, **there was no tax pyramiding to prevent**. Accordingly, the purposes of the exemption were not served. In light of this and the fact that a tax exemption is strictly construed, the court found that the exemption was not meant to apply to the extraction of water for personal use. Id. at 1252. (internal citation and quotation marks omitted). (**Emphasis added**).

Thus, the Tax Court in White River determined that WREP, like the taxpayer in Mumma Bros., was not entitled to statutory exemptions because WREP failed to demonstrate that it produced a marketable good. The tax Court concluded that "[w]here something is made, but not sold, the danger of tax pyramiding does not exist." Id.

In this instance, Taxpayer, like the taxpayers in Indianapolis Fruit, Mumma Bros., and White River, maintains that it is entitled to agricultural and manufacturing exemptions because it engages in producing "fertilizer" to be used in a farm. To support its protest, Taxpayer submitted photos with brief statements explaining its use of the tangible personal property. Taxpayer's documentation demonstrated:

> After picking up the sludge from its customers, Taxpayer hauls and delivers the sludge to its own lagoons, which are adjacent to the farm owned by an affiliate farming company which is solely owned by an individual, who also owns one-hundred percent share of Taxpayer. (i.e., the same person owns both companies, the farming company and Taxpayer–the trucking company.) Taxpayer then pumps the sludge from its trucks into its own lagoons. After the sludge is in the lagoons, Taxpayer then adds appropriate chemicals and monitors sludge until the sludge turns into fertilizer. Taxpayer then applies the fertilizer to the farm eventually.

At the administrative hearing, Taxpayer maintained that because the same individual owns both the farming company, which possessed the title of the farm, and Taxpayer, Taxpayer and the farming company are affiliates and, thus, are considered unitary. Therefore, Taxpayer believes that it is also considered a "farmer" and is entitled to receive the agricultural exemption. Additionally, Taxpayer stated that since the farming company and Taxpayer are affiliates, Taxpayer does not need to charge the farming company for the use of the "fertilizer" because the money goes to the same individual as a result. Taxpayer further argued that, regardless of the fact that Taxpayer did not charge for the "fertilizer," it is still entitled to receive the manufacturing exemption because it produces the "fertilizer"–a marketable good.

Taxpayer is mistaken. In this case, the issue is whether Taxpayer is entitled to statutory sales/use tax

exemptions for its purchases of tangible personal property. The facts that the farming company and Taxpayer are affiliates and, thus, they are considered unitary, though seemingly interesting theory, have no bearing in this protest and are beyond the scope of this protest. Moreover, Taxpayer is mistaken regarding its claim that the farming company is qualified for the agricultural exemption and so is Taxpayer because they are owned by the same individual. Taxpayer and its affiliate farming company have chosen to exist as separate entities. Taxpayer now wishes to pierce its own corporate veil to seek a sales and use tax advantage. There is nothing in IC § 6-2.5-1-3 defining "person" that allows a listed entity to change its status in order to seek a sales and use tax advantage. Taxpayer, not the farming company, made the purchases and claimed its entitlement to the exemptions, and thus the inquiry focuses on Taxpayer itself.

Additionally, even if, assuming that Taxpayer, like the taxpayer in Indianapolis Fruit, actively performed certain activities to cause the sludge to undergo a substantial change transforming the sludge into fertilizer, Taxpayer is still not entitled to the statutory exemptions because Taxpayer did not produce the fertilizer for sale.

Taxpayer's circumstances and its arguments are similar to those taxpayers' in Mumma Bros. and in White River Envtl. P'ship. Taxpayer did not sell or resell the fertilizer. Rather, Taxpayer used the fertilizer in the farm owned by its owner. In this instance, the Department's audit noted that Taxpayer's revenue is generated from trucking–hauling sludge, not from selling the fertilizer. Taxpayer also stated, at the administrative hearing, that the fertilizer is only used by the farming company in the farm next to its lagoons and it does not charge the farming company any fees for the use of the fertilizer because they are affiliates. Thus, since Taxpayer does not sell the fertilizer, Taxpayer is not in the business of producing a marketable good.

The case law has well established that the Indiana General Assembly "enacted the sales and use tax exemption in order to prevent tax pyramiding" and the exemptions were not meant to apply to the circumstances where the "fertilizer" is produced for Taxpayer and its affiliate's own use. Since Taxpayer does not sell the "fertilizer," it is not entitled to receive the exemptions pursuant to the above mention statutes, regulations, and case law. Also, since the Department determines that Taxpayer does not engage in production of a marketable good, the Department does not need to review whether the tangible personal property at issue is directly used in Taxpayer's direct production process.

In short, Taxpayer is not entitled to the agricultural and manufacturing exemptions.

FINDING

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:
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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.

Taxpayer has not provided 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 respectfully denied.

SUMMARY

For the reasons discussed above, Taxpayer's protest of the assessment of use tax on its purchases of tangible personal property is respectfully denied. Taxpayer's protest of the imposition of the negligence penalty is also respectfully denied.

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