

**Letter of Findings: 10-0247
Sales and Use Tax
For the Years 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 § 6-2.5-5-3; IC § 6-2.5-5-5.1; IC § 6-2.5-5-30; IC § 6-8.1-5-1; IC § 13-19-1-1; [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); Webster's II New Riverside University Dictionary (1st ed 1988).

Taxpayer protests the assessment of tax on its purchase 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 commercial printing company. The Indiana Department of Revenue ("Department") conducted a sales/use tax audit concerning Taxpayer's asset and expense purchases for tax years 2007 and 2008. Pursuant to the audit, the Department concluded that Taxpayer purchased a baler system without paying sales tax at the time of the purchase or self-assessing and remitting to the Department the use tax due. Thus, the Department's audit assessed Taxpayer additional use tax, interest, and penalty.

Taxpayer timely protested the assessments. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Exemptions.

DISCUSSION

The Department's audit assessed Taxpayer use tax on its purchase of the baler system. Taxpayer, to the contrary, claimed that it was entitled to a statutory exemption on its purchase of the baler system.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq. Generally, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable. [45 IAC 2.2-5-8\(a\)](#). An exemption from use tax is granted for transactions where the gross retail tax ("sales tax") was paid at the time of purchase pursuant to IC § 6-2.5-3-4. There are also additional exemptions from sales tax and use tax. A statute which provides a tax exemption, however, is strictly construed against the taxpayer. Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96, 97 (Ind. Ct. App. 1974).

IC § 6-2.5-5-3, in relevant part, 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.

IC § 6-2.5-5-5.1(b) provides:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture.

An exemption applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. [45 IAC 2.2-5-8\(a\)](#). Machinery, tools, and equipment are directly used in the production process if they have an immediate effect on the article being produced. [45 IAC 2.2-5-8\(c\)](#). A machine, tool, or piece of equipment has an immediate effect on the product being produced if it is an essential and integral part of an

integrated process that produces the product. Id. An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." [45 IAC 2.2-5-8](#)(c), example 1.

[45 IAC 2.2-5-8](#)(k) describes direct production as the performance of an integrated series of operations which transforms the matter into a form, composition or character different from that in which it was acquired, and that the change must be substantial resulting in a transformation of the property into a different and distinct product.

The exemption for direct use in production is 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](#).

Additionally, [45 IAC 2.2-5-8](#)(d) states:

Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

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

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

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

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

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

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

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

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](#), in relevant part, further states:

(a) 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 qauality [sic] statutes, regulations or standards; and the person acquiring the property is engaged in the business of manufacturing, processing, refining, mining, or agriculture.**

(b) Definitions. (1) Consumed as used in this regulation [[45 IAC 2.2](#)] means the dissipation or expenditure by combustion, use or application, and does not mean or include the obsolescence, discarding, disuse, depreciation, damage, wear or breakage of tools, machinery, devices or furnishings.

(2) Incorporated as used in this regulation [[45 IAC 2.2](#)] means the material must be physically combined into and become a component of the environmental quality device, facility, or structure. The material must constitute [sic] a material or integral part of the finished product. **(Emphasis added).**

In *Mechanics Laundry & Supply, Inc. v. Indiana Dep't of State Revenue*, 650 N.E.2d 1223 (Ind. Tax Ct. 1995), the taxpayer who rented clean textiles claimed that it was entitled to an exemption for its purchases of EPA compliance items (waste water treatment equipment) pursuant to IC § 6-2.5-5-30. As a general rule to interpret the Indiana tax statutes, the Tax Court in *Mechanics Laundry* stated:

Where words are used at one place in an Act, they will be construed as used in the same sense at other places in the Act, unless the clear context of the statute requires a different meaning. Further, when considering two or more statutes that relate to the same general subject matter, the court will read those statutes in *pari materia* and construe them together so as to produce a harmonious system.

The environmental quality exemption is part of the same act in which the equipment, consumption, and incorporation exemptions are found. In addition, the language of the environmental quality exemption is nearly identical to the language used in the equipment, consumption, and incorporation exemptions.... The environmental quality exemption must, therefore, be construed in harmony with the equipment, consumption, and incorporation exemptions. Accordingly, the term "processing," as it is used in the environmental quality exemption, has meaning only to the extent that goods or items of other tangible personal property are produced. Id. at 1232. (internal citations omitted).

The Court in Mechanics Laundry found that both the taxpayer and the Department stipulated that the taxpayer is "engaged in the production or manufacture of logos and name tags." Id. Based on the evidence presented, however, the Court in Mechanics Laundry determined that the taxpayer operated "its waste water treatment equipment in connection with the laundering of soiled textiles, but not in connection with the production of logos and names tags." Id. Thus, the Court in Mechanics Laundry concluded that the taxpayer, Mechanics Laundry & Supply, Inc., "is not entitled to receive the exemption for its purchases of EPA compliance items." Id.

Like the taxpayer in Mechanics Laundry, Taxpayer, in this instance, also claimed it was entitled to receive the exemption pursuant to IC § 6-2.5-5-30. Specifically, Taxpayer asserted that IC § 13-19-1-1 supports its protest because it acquired the baler system for the purpose of complying with IC § 13-19-1-1, the state environmental quality statute.

IC § 13-19-1-1 provides:

The policy of the state is that:

- (1) source reduction;
- (2) recycling; and
- (3) other solid waste management alternatives;

are preferred over incineration and landfill disposal as solid waste management methods.

Taxpayer maintained that, as a commercial printer, during the process of producing its finished products for the customers, such as brochures or pamphlets, the machine cuts and trims the edges of the paper and, thus, generates scrap paper. Taxpayer further stated that the baled scrap paper is more manageable for both Taxpayer and its vendors to remove and transport to recycling facilities. Therefore, Taxpayer believes that it acquired the baler system for the purpose of complying with the state recycling statute, IC § 13-19-1-1, and its purchase of the baler system should be exempt from sales/use tax according to IC § 6-2.5-5-30. To support its protest, Taxpayer submitted copies of photos that illustrated the use of the baler system and the Fact Sheet published by the Indiana Department of Environmental Management ("IDEM").

Taxpayer is mistaken. First of all, the word "comply" is defined as:

1. To act in accord with another request, command, rule, or wish. 2. Obs. To be courteous or obedient. Webster's II New Riverside University Dictionary 291 (1st ed 1988).

IC § 13-19-1-1 establishes the policy preference and general authority for IDEM's, a state agency, "solid waste management." IC § 13-19-1-1 does not apply to Taxpayer, a commercial printing company. Thus, Taxpayer's reliance is misplaced.

Even assuming, for the sake of argument, that IC § 13-19-1-1 is applicable in this instance, Taxpayer still is not entitled to receive the exemption for its purchase of the baler system according to Mechanics Laundry. Taxpayer's production process ends when the finished products—brochures or pamphlets—are produced. Therefore, the "scrap paper" is a by-product of Taxpayer's production process. Similar to the taxpayer's situation in Mechanics Laundry, Taxpayer's use of the baler system is not used in connection with the direct production process of its brochures or pamphlets. Instead, Taxpayer's use of the baler system is in connection with the disposition of the "scrap paper"—which is the by-product of Taxpayer's production process. The use of the baler system is, therefore, a post-production, and its use of the baler system is, at best, considered a practical necessity because it is easier to transport the baled scrap paper than scattered paper.

In short, Taxpayer is not entitled to receive the exemption for its purchase of the baler system. Since Taxpayer did not pay sales tax at the time of the purchase, use tax is properly imposed.

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:

- (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 of the imposition of the negligence penalty is respectfully denied.

SUMMARY

For the reasons discussed above, Taxpayer's protest of the baler system is respectfully denied. Taxpayer's protest of the imposition of the negligence penalty is also respectfully denied.

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