DEPARTMENT OF STATE REVENUE

04-20090014.SLOF

Supplemental Letter of Findings Number: 09-0014
Sales and Use Tax
For Tax Years 2005 and 2006

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 It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register.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. Sales and Use Tax–Imposition.

Authority: IC § 6-2.5-5-3; 45 IAC 2.2-5-8; 45 IAC 2.2-5-10; Indiana Dep't of Revenue v. Interstate Warehousing, Inc., 783 N.E.2d 248 (Ind. 2003); Indiana Dep't of Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983); North Cent. Industries, Inc., Company v. Indiana Dep't of Revenue, 790 N.E.2d 198 (Ind. Tax Ct. 2003); Rotation Products Corp. v. Dep't of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998); Indianapolis Fruit Company v. Indiana Dep't of State Revenue, 691 N.E.2d 1379 (Ind. Tax Ct. 1998); Mid-America Energy Resources v. Indiana Dep't of State Revenue, 681 N.E.2d 259 (Ind. Tax Ct. 1997); Harlan Sprague Dawley v. Indiana Dep't of State Revenue, 605 N.E.2d 1222 (Ind. Tax Ct. 1992); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991).

Taxpayer protests the imposition of use tax claiming that it is eligible 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 an Indiana company in the waste disposal and recycling/materials recovery business. After an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed use tax and assessed a negligence penalty for the 2005 and 2006 tax years. The Department found that Taxpayer had made a variety of purchases–including office supplies, computer software, freight/delivery charges, cleaning supplies, equipment, tools, and storage containers–upon which Taxpayer neither paid sales tax at the time of purchase nor remitted use tax to the Department.

Taxpayer protested the assessment of tax and penalty on two grounds: (1) it argued that the equipment at issue (forklifts, a loader, excavators, caterpillar, skid steer loaders, wrench grapple, bucket linkage shear, conveyor belts, shearers, balers, scales and similar machinery and equipment) qualified for the double-direct manufacturing exemption from sales and use tax; and (2) tax had been assessed on certain invoices that had not been available at the time of the audit, but which Taxpayer recovered. A hearing was held and a Letter of Findings (04-20090014.LOF) ("LOF") was issued denying Taxpayer on the first issue protested and conditionally sustaining Taxpayer on the second issue subject to supplemental audit verification. Taxpayer was denied waiver of the penalty. Taxpayer requested a rehearing on the first issue as well as the denial of penalty. The rehearing was granted and held. This Supplemental Letter of Findings ensues.

One minor point of clarification – the Department's audit refers to Taxpayer's three facilities, while Taxpayer's rehearing documentation refers to four facilities. Since the Department's audit was completed in 2008, it does not include a review of the fourth facility which began business according to Taxpayer's information in 2009. Taxpayer's description of activities at the fourth facility is ignored for purposes of this supplemental review. Further facts will be supplied as required.

I. Sales and Use Tax–Imposition.

DISCUSSION

The LOF cites to relevant statutory and case law, which is incorporated by reference here, and concludes that:

> In the instant case, Taxpayer does not add new parts to the articles; in most cases, Taxpayer merely separates and "repackages" the items. Taxpayer, at most, removes parts, separates items into groupings defined by their material composition, cleans items, and/or crushes items before bundling them into cubes-i.e., an all plastic cube or an all paper cube. The recyclable materials have no functionality as products, but only have value as the plastic, paper, metal, or other recyclable content. Taxpayer starts with scrap paper, plastic, and glass and then ends with scrap paper, plastic, and glass. Taxpayer does not create a new product–i.e., such as a new alloyed metal. Thus, while Taxpayer's customers may prefer to purchase only in cubes or bundles and pay Taxpayer for the convenience of these services, Taxpayer has merely repackaged the existing recyclable material. The Tax Court addressed the issue of repacking in North Cent. Industries, Inc., Co. v. Indiana Dep't of State Revenue, 790 N.E.2d 198, 201 (Ind. Tax Ct. 2003) and explained that "merely packag[ing] existing [property]... is not the sort of substantial change or transformation that places property 'in a form, composition, or character different from that in which [they were] acquired.' 45

IAC 2.2-5-8(k)."

Accordingly, since there is no new article produced, Taxpayer's activities do not pass the first factor of the Rotation Products test and review of the other factors is unnecessary. Therefore, under Interstate Warehousing, Taxpayer's activities do not qualify for the manufacturing exemption provided under IC § 6-2.5-5-3. Taxpayer should have paid sales tax on the items at the time of purchase. Since sales tax was not paid, use tax was properly imposed.

In conclusion, Taxpayer's activities do not constitute manufacturing as provided by Interstate Warehousing and Rotation Products. Sales tax should have been paid on the items in question at the time Taxpayer purchased them. Since sales tax was not paid, use tax was properly imposed.

Taxpayer's protest is based on the claim that its recycling activities constitute "manufacturing" therefore qualifying it for the double-direct manufacturing exemptions from sales and use tax. The LOF found that Taxpayer did not manufacture new products, but rather provided the service of repackaging the waste material it received at its facilities for its customers. Taxpayer requested a rehearing of the Department's decision in the LOF for several reasons: (1) Taxpayer claims the Department's LOF failed to apply the facts correctly; (2) Taxpayer claims the Department's LOF failed to address and properly apply case law; (3) Taxpayer claims the Department's LOF failed to address the Department's own interpretations and rulings; and (4) Taxpayer restates its protest of the assessment of negligence penalties.

Taxpayer offers a variety of waste removal options to residential, commercial, and industrial, and construction customers. Taxpayer recovers tons of materials at its three recovery and transfer facilities, both from its own waste removal services as well as from other waste removal operations.

At one of its facilities ("Facility 1") Taxpayer collects curbside recycling materials including plastic, glass, and aluminum products, as well as office paper, newspaper, and cardboard. According to the Department's audit, these items are sorted, graded, baled, and then sold to outside mills for processing. At Taxpayer's second facility ("Facility 2") recovery activities are dedicated to construction debris. This is mainly a transfer facility. According to the Department's audit, aggregates, metals, and cardboard are recovered and sold to mills across the state where the materials are then altered into another commodity. The scrap materials recovered here are broken down and/or sheared, and baled prior to being sold to mills. At Taxpayer's third facility ("Facility 3") recovery activities include cardboard, office paper, newspaper, magazines, and other types of paper. Materials recovered are sorted, graded, baled, and sold to mills where it is manufactured into a useable product.

Taxpayer maintains that these processes result in new, more marketable products and that Taxpayer is therefore entitled to the exemption found in IC § 6-2.5-5-3(b). Taxpayer is reminded the taxpayer claiming exemption has the burden of showing the terms of the exemption statute are met. General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991) aff'd 599 N.E.2d 588 (Ind. 1992) (Internal citations omitted). Additionally "[e]xemption statutes are strictly construed because an exemption releases property from the obligation of bearing its fair share of the cost of government." Id.

Taxpayer's first complaint is that the LOF "fails to apply the facts." Taxpayer states in its request for rehearing:

> [Taxpayer] acquires ownership of various forms of **waste** products (e.g. trash) which it uses as raw materials in its production process, and then converts these waste products into saleable goods in accordance with specifications required by [Taxpayer]'s customers. The raw materials acquired by [Taxpayer], in the form, shape and sizes required by [Taxpayer], do **not** meet [Taxpayer]'s customers' specifications. It is only after [Taxpayer] processes these materials and transforms them into a distinct marketable product meeting certain specifications can they be sold to these customers. The customer specifications were requested by the hearing officer, provided to the hearing officer, and then ignored by the hearing officer in the LOF.
>
> As raw materials for [Taxpayer]'s products, the waste products do not retain their form, shape, size, composition, or character. A coca-cola can ceases to be used as a drink container, or retain its form, shape or size as a drink container. Rather, it is crushed and becomes part of a much larger metal product. Its character changes from a drinking container to a crushed piece of metal within a larger product. Similarly, a milk container, whether paper or plastic, ceases to be used as a milk container, or retain its form, shape or size. It is also crushed and becomes part of a larger paper or plastic product, as the case may be. Its character changes from that of a milk container to a crushed piece of paper or plastic comprising a part of a larger product. The same is true with all of the other waste. In many cases, the form and composition of the waste is further changed by separating materials, breaking glass, cutting metal, etc. [Taxpayer] changes the form, composition and character of the waste products, converting them into a completely different product used for an entirely different purpose. The actual size, shape and weight of the product will vary depending upon the type of product, and the customer specifications. The average weights of the products range from 750 pounds, to 2,000 pounds. The length, widths and heights vary as well, generally between 35" and 65".
>
> Finally, [Taxpayer] converts **trash** into a saleable product through its production process. [Taxpayer] converts something that people throw away into a product that [Taxpayer]'s customers will buy, solely because [Taxpayer] creates a product, a product which meets its customers specifications, through [Taxpayer]'s production process.

The LOF ignores these critical facts.

The Department requested Taxpayer's customers' specifications during the hearing process in reference to Taxpayer's argument that it was producing items based on specifications required by its customers. The Department reviewed these materials thoroughly. The Department determined in its LOF that the resulting items did not constitute a manufactured product thus qualifying for the manufacturing exemptions. In other words, customer specifications did not, in this instance, translate into the sort of substantial transformation that the manufacturing exemptions contemplate. The Department did not ignore the facts that Taxpayer presented, the Department disagreed with the legal implication of these facts.

The Department also disagreed with the legal implications of the changes in these materials in terms of the form, shape, size, and composition. The Department's LOF describes the changes and discussed the legal framework through which it viewed these changes. Taxpayer, for example, stated that the coca-cola can is no longer a drinking container, nor is the milk container a milk container, but new marketable products. But Taxpayer forgets that the coca-cola can and the milk container had long ceased to be those items. These containers became waste the moment they were emptied by those who drank their contents. They arrived at Taxpayer's premises as **trash**. Those are the facts that the LOF states. The LOF did not ignore critical facts, it simply disagreed on their implications under Indiana's statutory manufacturing exemptions.

Taxpayer next argues on rehearing that the LOF "failed to address and properly apply case law." Taxpayer quotes from Indianapolis Fruit, 691 N.E.2d 1379 (Ind. Tax Ct. 1998) to assert that production "is defined broadly" and "focuses on the creation of a marketable good." Id. at 1383. However, the Department points the Taxpayer to the remaining portion of the paragraph from which Taxpayer quotes, which reads as follows:

> ... [M]athematical 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 1384.

Taxpayer refers to several Indiana court cases in support of its position, including: Indiana Dep't of Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983), Rotation Products Corp. v. Indiana Dep't of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998); Harlan Sprague Dawley v. Indiana Dep't of State Revenue, 605 N.E.2d 1222 (Ind. Tax Ct. 1992), Indianapolis Fruit Company v. Indiana Dep't of State Revenue, 691 N.E.2d 1379 (Ind. Tax Ct. 1998), Mid-America Energy Resources v. Indiana Dep't of State Revenue, 681 N.E.2d 259 (Ind. Tax Ct. 1997), Edgcomb Metals Co. v. Department of Local Government Finance, 762 N.E.2d 259 (Ind. Tax Ct. 2002), Monarch Steel Co. v. State Bd. of Tax Com'rs, 699 N.E.2d 809 (Ind.Tax,1998).

The holdings of the last two cases, Edgcomb Metals and Monarch Steel, will be ignored for the purposes of sales and use tax manufacturing exemptions analysis, because they have to do with inventory property tax. The cases analyze whether cutting steel is "processing" therefore subjecting the resulting property to inventory tax, or whether cutting the steel merely resulted in "repackaging" the steel, therefore exempting it from the property tax. It is worth noting that the case turns on the taxpayer's intent rather than the actual physical transformation of the material – the same physical act, cutting the steel, could be "processing" or "repackaging" depending on the taxpayer's intent in cutting the steel – thus lending no guidance in the current protest.

The first point Taxpayer makes relating to these cases responds to the LOF's statement that because Taxpayer "starts with scrap paper and ends with scrap paper" it does not qualify for the exemption. Taxpayer points out that this statement is "unsupportable under Indiana law." Taxpayer points out that in the cases listed above the taxpayers each started with a particular material and ended up with that same particular material. Taxpayer's point is well taken; however, the LOF's determination rested on its analysis of the nature of the physical changes that did take place relative to Taxpayer's materials and concluded that the changes that took place were not substantial enough to result in a new product.

Taxpayer then criticizes the LOF's reliance on Interstate Warehousing for the proposition that "any taxpayer claiming the exemption... must transform property into a 'distinct marketable product for customer consumption' in order to qualify for the exemption" because Interstate Warehousing rested on the fact that the taxpayer there did not sell any products, but rather provided a warehousing service. Taxpayer's technical criticism in this instance is not responsive to the substance of the LOF's reference to Interstate Warehousing. The LOF referred to a section of the case that addressed the issue of whether or not the chilled water produced by the taxpayer represented a transformation that rose to the level of a new product thus qualifying it for exemption. The Tax Court concluded that while there was a transformation that could qualify for exemption, Taxpayer nonetheless did not meet the equally important requirement of producing a marketable good; i.e., to sell a product. Taxpayer's criticism is in any case unnecessary, because the tenet expressed in the LOF's quote from Interstate Warehousing has become a basic tenet of all the recent cases that deal with the manufacturing exemption.

Taxpayer also cites to several Letters of Findings that previously supported similar though less complex recycling processes. However, as Taxpayer has been made aware since the rehearing, there are also other Letters of Findings that denied similar processes. Each Letter of Findings has its unique facts and circumstances that, while providing very general guidance to taxpayers with similar fact patterns, nonetheless stand alone as final determinations in each, separate, unique protest.

The Department's regulations emphasize that the tangible personal property that are the "raw materials" of a manufacturing/processing/refining process must be substantially changed in their "form, composition, or character" such that the resulting tangible personal property is a different product having a distinctive "name, character, and use." The resulting product must be substantially different from the component materials used.

45 IAC 2.2-5-8(k) states:

"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.

45 IAC 2.2-5-10(k) states:

Definitions. Processing or refining is defined as the performance by 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. Operations such as distilling, brewing, pasteurizing, electroplating, galvanizing, anodizing, impregnating, cooking, heat treating, and slaughtering of animals for meal or meal products are illustrative of the types of operations which constitute processing or refining, although any operation which has such a result may be processing or refining. A processed or refined end product, however, must be substantially different from the component materials used.

Taxpayer's argument essentially rests on the following points:

First, "the form, composition, or character" of the materials is changed. The trash is transformed, whether through crushing, shredding or cutting, there is a physical transformation that changes the form of the trash and its character.

However, in the instant case, Taxpayer does not add new parts to the articles being disassembled, but instead removes parts and separates them into groupings defined by their material composition. The disassembled parts themselves have no value as parts. The only value is the metal or other recyclable content. The recyclable materials have no functionality and, after removal from the original article, have no value as parts. Since there is no new article produced, Taxpayer's activities do not pass the first factor of the Rotation Products test and review of the other factors is unnecessary. Therefore, under Interstate Warehousing, Taxpayer's activities do not qualify for the manufacturing exemption provided under IC § 6-2.5-5-3. Therefore, Taxpayer should have paid sales tax on the items at the time of purchase. Since sales tax was not paid, use tax was properly imposed.

Second, Taxpayer argues that a new marketable product is created because the bundles are to customer specifications – i.e., the resulting bundles are marketable because they are what the customers want. However, in Faris Mailing, Inc. v. Indiana Dep't of State Revenue, 512 N.E.2d 480 (Ind. Tax Ct. 1987), while the final "product," the mailing, was designed to customer specifications, the Tax Court nonetheless did not find that packaging various materials to customer specifications in and of itself qualified for the creation of a product under the manufacturing exemption statutes. Therefore, simply putting components together, even if to customer specifications, is not enough to meet the requirements of production absent substantial transformation of the component materials.

The Department does not disparage the rationale of Taxpayer's protest or seek to underestimate the value of Taxpayer's operations nor does it treat as insignificant the costs related to those operations. However, in asking the question of whether the Taxpayer's recycling process results in a "substantially different" product, the Department concludes that it does not; the glass, cardboard, paper, and metal cans introduced at the beginning of Taxpayer's process remains glass, cardboard, paper, and metal cans at the end of that process. In answering the question of whether Taxpayer's recycling activity can be "strictly construed" as entitled to an exemption under IC § 6-2.5-5-3-(b) the Department must likewise conclude that it does not. Taxpayer's protest de facto seeks by administrative review to broaden the statutory sales and use tax exemptions to include recycling equipment; the expansion of this exemption is a task more properly addressed by the General Assembly.

Taxpayer's activities do not qualify for the manufacturing exemption provided under IC § 6-2.5-5-3. Taxpayer, therefore, should have paid sales tax on the items at the time of purchase. Since sales tax was not paid, use tax was properly imposed.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration–Negligence Penalty.

DISCUSSION

Taxpayer protests 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:

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 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 affirmatively established that its failure to pay the deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

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

CONCLUSION

Taxpayer's protest to the imposition of use tax is denied since it is ineligible for the manufacturing exemption.
Taxpayer's protest to the imposition of penalty is sustained.

Posted: 02/23/2011 by Legislative Services Agency
An html version of this document.