DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 04-20100359
Sales and Use Tax
Tax Years: 2007 and 2008

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ISSUE

I. Sales and Use Tax – Manufacturing 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 § 6-8.1-5-1; 45 IAC 2.2-5-8; 45 IAC 2.2-5-11; Chrome Deposit Corp. v. Indiana Dept. of Revenue, 557 N.E.2d 1110 (Ind. Tax Ct. 1990), aff'd, 578 N.E.2d 643 (Ind. 1991); Rotation Products Corp. v. Indiana Dept. of State Revenue, 690 N.E. 2d 795 (Ind. Tax Ct. 1998); Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dept. of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974).

Taxpayer protests the assessment of gross retail tax.

II. Tax Administration – Ten Percent Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of the negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana corporation that provides a roll grinding service to customers that need both new and used work rolls repaired. Taxpayer purchased several items for use in its grinding operations. The Department conducted a sales and use tax audit of the 2007 and 2008 tax years. The audit determined that Taxpayer should have paid sales tax on the purchases during the tax years in question, and was charged sales tax as a result. Taxpayer was also assessed penalty and interest. Taxpayer protests the assessment of sales tax and the assessment of penalty. A hearing was held on the matter, and this Letter of Findings results.

I. Sales and Use Tax – Manufacturing Exemptions.

DISCUSSION

Taxpayer receives work rolls from customers for repair. Two work rolls are used together to make flattened products: steel products, food, wood, etc. Taxpayer's customers include both the companies that use the work rolls in their business operations, as well as the original equipment manufacturers. The audit concluded that Taxpayer is performing a repair service, rather than remanufacturing the work rolls to make new products.

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 Dept. 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 Dept. of State Revenue v. RCA Corp., 310 N.E.2d 96, 97 (Ind. Ct. App. 1974).

IC § 6-2.5-5-3(b) states in relevant part:

> [T]ransactions 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 further explained at 45 IAC 2.2-5-11, in part, as follows:

(a) The state gross retail tax shall not apply to sales of tangible personal property to be directly used by the purchaser in the direct production or manufacture of any manufacturing or agricultural machinery, tools, and equipment described in IC 6-2.5-5-2 or 6-2.5-5-3 [IC 6-2.5-5-3].

(b) The exemption provided in this regulation [45 IAC 2.2] extends only to tangible personal property directly used in the direct production of manufacturing or agricultural machinery, tools, and equipment to be used by such manufacturer or producer.

(c) The state gross retail tax shall not apply to purchases of tangible personal property to be directly used by the purchaser in the production or manufacturing process of any manufacturing or agricultural machinery, tools, or equipment, provided that the machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect upon the article being produced or manufactured. The 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.

(d) For the application of the rules [subsections] above, refer to Regs. 6-2.5-5-3 [45 IAC 2.2-5-8 through 45 IAC 2.2-5-10] with respect to tangible personal property used directly in the following activities:

pre-production and post-production activities; storage; transportation; tangible personal property which has an immediate effect upon the article produced; maintenance and replacement; testing and inspection; and managerial, sales, and other nonoperational activities.

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.

As stated above, taxpayer bears the burden of proof to overcome the Department's assessment. Rotation Products Corp. v. Indiana Dept. of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998), which also involved a taxpayer that claimed the equipment and consumption manufacturing exemptions, stated that "exemptions are strictly construed against the taxpayer." Id. at 798. Thus, the taxpayer in Rotation Products bore the burden to demonstrate its eligibility for the exemptions. "After all, it is the taxpayer who knows his business, and it is the taxpayer who seeks the exemption." Id. In order for Taxpayer to benefit from the exemption stated above, Taxpayer must meet the threshold question of whether Taxpayer's activities qualify as a manufacturing process.

The taxpayer in Rotation Products claimed that it was remanufacturing ball bearings and was therefore eligible for the manufacturing exemption. The court explained:

Usually, a substantial amount of work will have to be performed to transform materials with only scrap value into serviceable and marketable products. In most cases, the substantial amount of work required will "result in an 'end product' that is 'substantially different from the component materials used.'"

Id., at 802. The court in Rotation Products illustrated that a taxpayer can be considered a remanufacturer if the taxpayer's repair activity was directly involved in the creation of a product. Id. at 799. The Rotation Products court established a four-part test of determining what repair activity might rise to the level of remanufacturing, as follows:

1) The substantiality and complexity of the work done on the existing article and the physical changes to the existing article, including the addition of new parts;

2) A comparison of the article's value before and after the work;

3) How favorably the performance of the remanufactured article compares with the performance of newly manufactured articles of its kind; and

4) Whether the work performed was contemplated as a normal part of the life cycle of the existing article.

Id. at 802-03. Therefore, like the taxpayer in Rotation Products, Taxpayer must satisfy all of the above to be considered a remanufacturer of rolls.

Taxpayer maintains that they meet all four parts of the Rotation Products test, and thus are remanufacturers of a product rather than simply providing a repair service. Customers send Taxpayer both new and used rolls, which Taxpayer explains "are not usable by the standards set in the original engineering of the product." In the case of a used roll, it is first inspected to determine whether the roll is salvageable, whereas new rolls do not need to be inspected as they are inspected by the original equipment manufacturer. Then, in the case of new rolls and salvageable used rolls, coating "[m]aterial is removed with an abrasive grinding wheel so that there is a specific visual quality, a measurable scratch pattern, and a measurable shape." Next, the roll is visually inspected, whereafter it goes through a sarclad ("eddy current tester") inspection to determine if there is any bruising or if there are any cracks. The roll is then inspected with an ultrasound to find any surface cracks. After this inspection, the roll is inspected for hardness using an "equotip" (which if "it does not meet minimum values [of hardness the] the roll [cannot] be used"). After all of these inspections, if it is not viable for refinishing, it is scrapped. If the roll is viable for refinishing, then the grinding is completed. Electronic devices are then used to check the scratch pattern

and profile for roughness. Chrome plating may be added at this point by a vendor with whom Taxpayer subcontracts. It is oiled and wrapped and then sent to the vendor. When Taxpayer gets the work roll back from the vendor, it checks the coating quality and thickness and then packages the work roll and ships it back to the customer.

As stated above, Taxpayer must satisfy all of the four prongs of Rotation Products test to be considered a remanufacturer of cylinders. Taxpayer meets the second prong of the Rotation Products test, as the work roll would have no value as a work roll since it is unusable in the state at which it is brought to Taxpayer for repair. Similarly, the third prong of the Rotation Products test has been met, since Taxpayer has provided sufficient evidence to show that it is understood by Taxpayer's customers that the refurbished rolls perform as well as brand new work rolls. The fourth prong of Rotation Products looks at whether the work performed was contemplated as a normal part of the life cycle of the existing article. Taxpayer asserts that their customers understand that when they send the work rolls to Taxpayer, there is a possibility that the rolls won't be salvageable.

It is the first prong of the Rotation Products test which Taxpayer fails to meet. Although Taxpayer has demonstrated that its process of grinding and examining the work rolls is complex, Taxpayer's work does not significantly change the work rolls. Taxpayer grinds away the imperfections found in the work rolls, both on the main surface and other surfaces as well. However, it neither removes tangential items connected to the work roll nor adds items to the work roll, unlike in Rotation Products, where the company removed rolling elements and roller cages from the roller bearings and replaced them with new ones after the grinding process was finished. In fact, the adding of an application of chrome plating is performed by another company altogether. Taxpayer merely inspects the work roll after it has been chrome plated. As provided by Rotation Products, a taxpayer's activities must result in something new in order to qualify for the exemption found in IC § 6-2.5-5-3(b). Here, the activities result in the same work rolls delivered to Taxpayer ending up repaired, if it is not scrapped. The end result is certainly not a new product.

In addition, Taxpayer directs the Department's attention to Chrome Deposit Corp. v. Indiana Dept. of State Revenue, 557 N.E.2d 1110 (Ind. Tax Ct. 1990). In that case, the court held that cleaning supplies were exempt from Indiana sales and use tax pursuant to IC § 6-2.5-5-3 when they were found to be an essential and integral part of the production process. Chrome Deposit, 557 N.E.2d at 1118. The taxpayer manufactured layered hard chromium metal (a chromium sleeve) that was applied to customers' work rolls. Prior to application, the work rolls were "placed into a 'scrub tank' and physically scrubbed with sponges, water, and a special cleaning material that removed surface impurities." Id. The court held that "[t]hese cleansing items [were] an essential and integral part of the integrated process by which the hard chromium metal is produced and applied to the work rolls." Id. For these reasons, the court found that Chrome Deposit could take advantage of the industrial exemptions for its cleaning supplies. Id.

Taxpayer contends that its position is analogous to that of Chrome Deposit, and similarly, Taxpayer's purchases should enjoy exempt status. Further, Chrome Deposit Corporation is actually one of the subcontractors that apply the chrome plating to work rolls for Taxpayer, and Taxpayer contends that if they were found to be exempt, then Taxpayer should be found exempt as well.

The Department disagrees. Although the facts are somewhat similar, the holding in Chrome Deposit applied to a company that was applying chrome plating to work rolls, whereas Taxpayer does not provide this service, instead subcontracting it out.

Since Taxpayer has not shown that they are remanufacturing the rolls and providing anything other than a repair service, Taxpayer has not met its burden of proof.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration – Ten Percent Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty and interest for the tax years in question. Taxpayer protests the imposition of penalty, requesting that it be waived.

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.

45 IAC 15-11-2(c) provides that:

> 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.

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

FINDING

Taxpayer's protest is respectfully denied.

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