DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 04-20100466
Use Tax
For Tax Years 2007-09

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ISSUES

I. Use Tax–Imposition.

Authority: General Motors Corp. v. Indiana Dep't of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); North Cent. Industries, Inc. v. Indiana Dep't of State Revenue, 790 N.E.2d 198 (Ind. Tax Ct. 2003); IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-8.1-5-1; IC § 6-2.5-5-3; 45 IAC 2.2-1-1; 45 IAC 2.2-3-4; 45 IAC 2.2-5-8.

Taxpayer protests the imposition of use tax on certain purchases it believes are exempt from use tax.

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. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had made purchases of tangible personal property but had not paid sales tax on those purchases. The Department therefore issued proposed assessments for use tax, interest, and ten percent negligence penalties for the tax years 2007, 2008, and 2009. Taxpayer protests the imposition of use tax on some of the items included in the Department's calculations. Taxpayer also protests the imposition of ten percent negligence penalties. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Use Tax–Imposition.

DISCUSSION

Taxpayer protests the imposition of use tax on certain items it purchased during the tax years 2007-09. The Department determined that Taxpayer had not paid sales tax on the purchase of these items and therefore use tax was due. Taxpayer protests that the items in question qualify for various exemptions from use tax. 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 the items qualify for various exemptions. The first item is an uncoiler upon which steel coils are loaded for uncoiling. Taxpayer believes that the uncoiler qualifies for the manufacturing exemption found at 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).

As provided under IC § 6-2.5-5-3(b), items must meet the "double direct" test in order to qualify for exemption. The Indiana Tax Court has addressed the question of what constitutes a manufacturing operation. In General Motors Corp. v. Indiana Dep't of State Revenue, 578 N.E.2d 399, 401 (Ind. Tax Ct. 1991), the Court provided:

> The double direct standard, expressed in the statutory language emphasized above, is the touchstone of the equipment exemption from sales/use tax. In Indiana Department of State Revenue v. Cave Stone, Inc. (1983), Ind., 457 N.E.2d 520, the seminal case interpreting the double direct standard, the Indiana Supreme Court recognized the essential and integral test to determine whether the double direct standard is met. The court held the transportation equipment at issue was both essential to transforming crude stone into a marketable product and integral to "the ongoing process of transformation." Id. at 524.

Additionally, the Indiana Tax Court explained in North Cent. Industries, Inc. v. Indiana Dep't of State Revenue, 790 N.E.2d 198, 200 (Ind. Tax Ct. 2003):

> To qualify for the equipment exemption, North Central must show, in part, that it is engaged in the direct production or manufacture of other tangible personal property. See Gen. Motors Corp. v. Indiana Dep't of State Revenue, 578 N.E. 2d 399, 401 (Ind. Tax Ct. 1991), aff'd. **If it satisfies this element, North Central must then show that the equipment for which it seeks an exemption is directly used in the production of the tangible personal property**. See Id.
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> Although "[t]here are innumerable ways to produce other tangible personal property, [Indiana Code Section 6-2.5-5-3] cannot be expected to give a precise answer to each factual situation that arises." Rotation Prod., 690 N.E.2d at 798. **Nevertheless, the Department's rules make clear that production must entail a "substantial" change or transformation that "places tangible personal property in a form, composition, or character different from that in which it was acquired."** IND. ADMIN. CODE tit. 45, r. 2.2-5-8(k) (2001). Moreover, production must increase the number of "scarce economic goods," i.e., it must create a new, marketable product. Harlan Sprague Dawley, Inc. v. Indiana Dep't of State Revenue, 605 N.E.2d 1222, 1226 (Ind. Tax Ct.1992) (quoting Borden Co. v. Borella, 325 U.S. 679, 65 S.Ct. 1223, 89 L.Ed. 1865 (1945)).
>
> (**Emphasis added**).

The Department determined that the uncoiler was used in pre-production and was therefore not eligible for the manufacturing exemption.

A review of the materials provided at the hearing and in the hearing process establishes that the uncoiler in question is used in the production process. The uncoiler is not only connected to the stamping machine physically, but is also controlled by the same computer which controls the stamping machine which stamps the sheet of metal being uncoiled. That single computer ensures that the proper tension is maintained on the sheet metal while it is on both the uncoiler and the stamping machine, constituting a single production process by which the uncoiler is directly involved in the direct manufacture of Taxpayer's marketable product. Therefore, with regard to the uncoiler, Taxpayer has met the burden imposed by IC § 6-8.1-5-1(c).

The next category under protest is a scrap conveyor. Taxpayer states that the conveyor is a component part of various pieces of exempt equipment and therefore Taxpayer believes that the conveyor qualifies for the manufacturing exemption. After a review of the documentation supplied in the protest process, the Department is unable to agree that the conveyor is a part of the manufacturing process. While the conveyor does remove scrap from the manufacturing site, it is not directly used in the direct production of Taxpayer's product. Any manufacturing is done prior to the operation of the conveyor. Therefore, the conveyor does not pass the double direct test described above.

The next category of items under protest is cranes used to move heavy materials and equipment. Taxpayer protests that the cranes are essential to move the heavy materials and equipment and that the production process could not happen without this function. As the court explained in North Central Industries, a taxpayer claiming the manufacturing exemption must show that the equipment for which it seeks an exemption is directly used in the production of the tangible personal property. While the cranes are undoubtedly necessary to lift the heavy materials and equipment, they are not directly used in the direct production of Taxpayer's product. Therefore, the cranes do not qualify for the manufacturing exemption.

Taxpayer also contends that the cranes are used to take dies in a loop from the production process to the die maintenance area in a manner similar to a cooling tower loop. Taxpayer reasons that, since a cooling tower loop is exempt then the die production/maintenance loop should also be exempt. The relevant regulation is 45 IAC 2.2-5-8(h), which provides:

> Maintenance and replacement equipment.
>
> (1) Machinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax.

(2) Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax.

–EXAMPLE–

A manufacturer of sheet metal repairs and upgrades used machinery by replacing worn or broken parts and adding new elements and features available in state-of-the-art equipment. All items which become components of the upgraded machinery are exempt from tax. However, all tools and equipment used to repair or upgrade used machinery would be taxable.

The cranes in question here are used in the process of moving dies from the production area to the maintenance area and back. This constitutes a maintenance use and makes the cranes subject to sales and/or use tax, as provided by 45 IAC 2.2-5-8(h).

Similarly, Taxpayer protests that the Department imposed use tax on three tool changers it uses to assist in the automatic changing of welding jigs. The Department considered the tool changers to be used between production runs and separate from the production process. After review of Taxpayer's description and additional documentation, it is clear that the tool changers are attached to and integrated with the exempt welders and their controls. Therefore, the tool changers qualify for the manufacturing exemption provided by IC § 6-2.5-5-3.

The next protest category is ductwork and a related fan which Taxpayer believes qualify for the safety equipment exemption. This exemption is found at 45 IAC 2.2-5-8(c), which provides in relevant part:

-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.

...

(F) Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.

....

(Emphasis added).

Also, 45 IAC 2.2-5-8(j) provides:

Managerial, sales, and other non-operational activities. Machinery, tools, and equipment used in managerial sales, research, and development, or other non-operational activities, are not directly used in manufacturing and, therefore, are subject to tax. This category includes, but is not limited to, tangible personal property used in any of the following activities: management and administration; selling and marketing; exhibition of manufactured or processed products; safety or fire prevention equipment which does not have an immediate effect on the product; space heating; ventilation and cooling for general temperature control; illumination; heating equipment for general temperature control; and shipping and loading.

(Emphasis added).

Taxpayer believes that the air ducts and fan allow its employees to participate in the production process without injury by clearing fumes from the parts service center, thereby qualifying for the safety equipment exemption.

The Department does not agree with this conclusion. As provided by 45 IAC 2.2-5-8(c) example (2)(F), the equipment must allow a worker to participate in the production process without injury. As explained in the audit report, the ducts and fan provide general ventilation for the entire plant. Therefore, while these items might remove fumes from the parts service center, they are not specifically dedicated to that task. They serve a general ventilation purpose and therefore they do not qualify for the exemption as explained by 45 IAC 2.2-5-8(c) example (2)(F) and 45 IAC 2.2-5-8(j).

In conclusion, Taxpayer is sustained on its protest of the uncoiler and the three tool changers. These items are integrated with and controlled by the manufacturing process and are directly used in the direct production of Taxpayer's product. Taxpayer's protest is denied regarding the scrap conveyor, cranes, and air ducts and fan. These items are not directly used in the direct production of Taxpayer's product and do not qualify for the manufacturing exemption. The air ducts and fan do not qualify for the safety equipment exemption. The cranes are used in the maintenance of the dies, and are properly subject to use tax.

FINDING

Taxpayer's protest is sustained in part and denied in part.

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 some items protested in Issue I above. However, there remain several items which were not protested and which were taxable. Taxpayer has not established that the assessment of additional 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 partially sustained and partially denied on Issue I regarding the imposition of use tax on the protested items. The uncoiler and tool changers are exempt from use tax. The remaining protested items are subject to use tax. Taxpayer is denied on Issue II regarding imposition of penalty.

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