

Letter of Findings: 04-20140106
Use Tax
For the 2011 Tax Year

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is suspended by the publication of another document in the Indiana Register.

ISSUES

I. Use Tax – Agricultural Equipment Exemption.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-4; IC § 6-2.5-5 et seq; IC § 6-2.5-5-1; IC § 6-2.5-5-2; IC § 6-8.1-5-1; [45 IAC 2.2-5-4](#); [45 IAC 2.2-5-6](#); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indianapolis Fruit Co. v. Indiana Dep't of State Revenue, 691 N.E.2d 1379 (Ind. Tax Ct. 1998); Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); Sales Tax Information Bulletin 9 (August 2008).

Taxpayer protests the imposition of use tax on agricultural equipment.

II. Tax Administration – Ten Percent Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the assessment of negligence penalty.

STATEMENT OF FACTS

Taxpayer owns and operates a farm in Indiana. In 2011, Taxpayer purchased a John Deere RC 72 Rotary Cutter ("rotary cutter") and a John Deere Demo Field Kit ("demolition kit") in a retail transaction in Indiana for use on his farm. Taxpayer did not pay sales tax at the point of purchase believing that the items qualified for the agricultural equipment exemption. The Indiana Department of Revenue ("Department") investigated these purchases and determined that the items were not "directly used in the direct production of food or commodities" and therefore did not qualify for exemption from sales tax. Having not paid sales tax at the point of purchase, the Department therefore determined that Taxpayer owed use tax, penalty and interest on its use of this farm equipment. Taxpayer protested the imposition of use tax because Taxpayer continues to believe the equipment qualifies for the sales and use tax agricultural equipment exemption. An administrative hearing was conducted, and this Letter of Findings results. Further facts will be provided as necessary.

I. Use Tax – Agricultural Equipment Exemption.

DISCUSSION

Taxpayer protested the Department's assessment of use tax on its use of a rotary cutter and a demolition kit used on the rotary cutter. Taxpayer believes that these items are exempt from sales tax, and subsequently use tax, because they are essential and integral to his farming operations.

As a preliminary matter, all tax assessments are prima facie evidence that the Department's claim for the 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).

Furthermore, all tax exemption provisions are strictly construed against exemption from the tax. Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999).

Indiana imposes a sales tax on retail transactions and a generally complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-2-1. An exemption from the 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. Therefore, when tangible personal property is used, stored, or consumed in Indiana, use tax is due unless sales tax was paid at the time of the transaction.

The Indiana Code provides other exemptions from sales/use tax. IC § 6-2.5-5 et seq. IC § 6-2.5-5-1 and IC § 6-2.5-5-2 state exemptions for tangible personal property used in agricultural production. These exemptions require a taxpayer to be engaged in agricultural production. The fact that an item is purchased for use on a farm does not necessarily make it exempt. [45 IAC 2.2-5-4](#)(e). A taxpayer must also show how the tangible personal property for which it seeks an exemption is directly used in its direct production process. IC § 6-2.5-5-1(a); Indianapolis Fruit Co. v. Indiana Dep't of State Revenue, 691 N.E.2d 1379, 1383 (Ind. Tax Ct. 1998).

IC § 6-2.5-5-2 states the exemption for agricultural equipment and machinery:

- (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).

When Taxpayer purchased the rotary cutter and the demolition kit, Taxpayer provided the vendor with an exemption certificate and therefore did not pay sales tax on these items at the time of the purchase.

[45 IAC 2.2-5-4](#) elaborates on the agricultural exemptions, also providing some examples of items that qualify for exemption:

- (a) Agricultural exemption certificates may be used only if the purchaser is occupationally engaged in the business of producing food or commodities for human, animal, or poultry consumption for sale or for further use in such production.
- (b) The department has determined that persons occupationally engaged in producing food and commodities as used in the Indiana sales and use tax act, shall mean and include only those persons, partnerships, or corporations whose intention it is to operate a farm at a profit and not those persons who intend to operate a farm for pleasure as a hobby. Operations similar to those of a pony farm, riding stable, or the production and raising of dogs and pets, are not classified as farms for the purpose of the state gross retail tax act.
- ...
- (d) Each of the following items is considered exempt from the sales tax ONLY when the purchaser is occupationally engaged in agricultural production and uses the items directly in direct production of agricultural products.

EXEMPT TRANSACTIONS

- (1) Livestock and poultry sold for raising food for human consumption and breeding stock for such purposes.
- (2) Feed and medicines sold for livestock and poultry described in Item (1).
- (3) Seeds, plants, fertilizers, fungicides, insecticides, and herbicides.

(4) Implements used in the tilling of land and harvesting of crops therefrom, including tractors and attachments.

(5) Milking machines, filters, strainers, and aerators.

(6) Gasoline and other fuel and oil for farm tractors and for other exempt farm machinery.

(7) Grease and repair parts necessary for the servicing of exempt equipment.

(8) Containers used to package farm products for sale.

(9) Equipment designed to haul animal waste.

(10) Equipment such as needles, syringes, and vaccine pumps.

(e) The fact that an item is purchased for use on the farm does not necessarily make it exempt from sale [sic] tax. It must be directly used by the farmer in the direct production of agricultural products. 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 agricultural products. **The fact that a piece of equipment is convenient, necessary, or essential to farming is insufficient in itself to determine if it is used directly in direct production as required to be exempt.**

(f) If a farmer makes a purchase tax exempt and later determines that the purchase should have been taxable, a use tax is due on the purchase price and should be remitted to the department of revenue along with the next annual income tax return, except for sales tax on gasoline which must be shown on the claim for motor fuel tax refund.

(Emphasis added).

Sales Tax Information Bulletin 9 (August 2008), 20080827 Ind. Reg. 045080655NRA, also discusses the exemption of machinery, tools, and equipment directly used for the direct production of food for sale by a person occupationally engaged in the production of food. The Information Bulletin states in relevant part:

I. Purchases

The general rule for the application of sales or use tax is that a purchase of tangible personal property to be used in Indiana is subject to tax unless a specific exemption is available.

Indiana law provides several exemptions from sales and use tax relating to agricultural production. The exemptions are limited to purchases of animals, feed, seed, plants, fertilizer, insecticides, fungicides, and other tangible personal property; and agricultural machinery, tools, and equipment to be directly used in the direct production of food or commodities that are sold either for human consumption or for further food or commodity production.

The phrase "directly used in direct production" means that the property must be integral and essential to the production process. Property is integral and essential to the production of food or commodities if it is necessary to carry on production and plays a key role in the actual production of the food or commodity. Some examples of property that are directly used in direct production are discussed later.

...

B. Agricultural Machinery, Tools, and Equipment

The purchases of agricultural machinery, tools and equipment are exempt from sales and use tax if the machinery, tools and equipment are directly used in the direct production, extraction, harvesting, or processing of agricultural commodities. If the machinery or equipment is not directly used in the direct production of agricultural commodities, but is designed for use in the gathering, moving, or spreading of animal waste, the machinery or equipment may be exempt if the following conditions are met:

1. The person acquiring the equipment acquires it for use in conjunction with the production of food or

commodities for sale.

2. The person acquiring the machinery or equipment is occupationally engaged in the production of food or commodities that are sold for human or animal consumption or are used for further food or commodity production.
3. The machinery or equipment is designed for use in gathering, moving, or spreading animal waste.

Examples:

1. Fencing used to confine livestock during breeding, gestation, farrowing, calving, nursing and finishing is exempt from tax. During these activities, the fencing plays a key role in the raising of the livestock.
2. John Doe, a cattle rancher, purchases needles, syringes and vaccine pumps to inoculate his herd to prevent various cattle diseases. The equipment is exempt from tax because it is essential and integral to the raising of cattle. Without vaccinations, many of John's cattle could die.
3. Sam Johnson owns 800 acres and grows wheat to be sold to a corporate bakery. Sam purchased lumber, nails, concrete, and tools to build a silo to house his grain-drying operation. The lumber and other building materials are exempt from tax; the silo is exempt from tax because the grain-drying operation is integral and essential to the processing of the grain. The grain cannot be sold to Sam's customer until it is dried, thus the silo is necessary and plays a key role in the processing of the grain. The tools used to build the silo are taxable because the tools are not used in the processing of the grain.
4. Sam Johnson buys lumber, nails and concrete to build a silo to store grain after it has dried. Sam sells the grain to his customer after the grain is dried without further processing. The materials used to build the silo are taxable. Once the grain has dried, no further processing takes place before the grain is sold, thus the processing of the grain is complete after drying. A silo used to store dried grain may be necessary, but it does not play a key role in the processing of the grain because the processing of the grain is finished. If the storage silo were used half of the time to dry grain and the other half to store dried grain, then the silo would be 50 percent exempt and 50 percent taxable. If Sam also operated a mill where the grain was ground, then the dried grain storage silo would be exempt from tax. The silo would be exempt because the silo would be a temporary storage place for work in process. The courts have determined that the temporary storage of property between processing steps is integral and essential to an integrated production process.
5. Corporation C is engaged in the business of selling agricultural chemicals and fertilizers to farmers. Corporation C purchases an applicator that will be used to spread the chemicals and fertilizer on its customers' fields. The purchase of the applicator is exempt from tax because the application of fertilizers and agricultural chemicals is necessary and plays a key role in the raising of crops.
6. Corporation A runs a large hog farm operation where pigs are bred, raised, slaughtered, and packaged to be sold to wholesale grocers. The pigs are kept in confinement buildings. The confinement buildings maintain the integrity of the product and control the animals' growth environment to facilitate the raising process. Any property directly used in the process of raising the pigs, such as heat exchangers, fans, thermostats, heat pumps, roof vents, and the confinement stalls or porches, would be eligible for exemption. These materials are exempt because if a person occupationally engaged in producing food for human consumption chooses to raise livestock in confinement buildings, these materials are both essential and integral to the production process.

There is no question that Taxpayer is a farmer engaged in the direct production of food or agricultural commodities and is entitled to claim the exemption for equipment directly involved in the direct production of that personal property. The issue is whether the rotary cutter and the demolition kit that Taxpayer purchased are employed within Taxpayer's production process and therefore exempt from sales and/or use tax. In other words, is the equipment used directly in the direct production of agricultural products (referred to also as the "double direct test")?

Taxpayer explained that his farmland has a lot of trees and is especially heavily wooded around the perimeter. According to Taxpayer the trees and brush naturally encroach on tillable land and must be regularly maintained to prevent the encroachment. Taxpayer states that the rotary cutter at issue is an industrial strength chopper. The rotary cutter, according to Taxpayer (and John Deere's website) takes down trees up to 4 inches in diameter and breaks them up (https://www.deere.com/wps/dcom/en_US/products/attachment/worksite_pro_attachments/rotary_cutters/rc72/rc72.page) (as visited April 30, 2014). This process is not safe according to Taxpayer, which is why he also purchased the demolition kit. This is a kit for the rotary cutter that is comprised of a door with bullet proof glass and mounting brackets and is a required purchase. The kit protects the operator of the cutter from injury from debris propelled by the cutter. According to Taxpayer most farmers use harsh

herbicides to control the encroachment. Taxpayer states that he prefers to avoid the indiscriminate use of harsh chemicals in order to protect non-targeted plants, ground water, wildlife, etc. Therefore, in lieu of chemical control, he uses a mechanical method to control the encroachment. Taxpayer adds that "the items in question cannot be used for routine mowing of grass, such as waterways, roadsides, barn lots, et cetera." Taxpayer states that he has other mowers for routine mowing.

Therefore, Taxpayer argues, these items that are used exclusively for the control of encroachment of unwanted plants, trees, vines "have a direct and immediate impact upon the production of agricultural commodities, and are exempt [. . .]. Taxpayer uses as an example a tract of land he purchased in 2013 that had not been properly maintained to control encroachment which dramatically reduced the field's agricultural area. "In short," Taxpayer states, "controlling the encroachment process has a direct and immediate impact on the production of agricultural commodities." By this, Taxpayer argues that without preparing and protecting the tillable land, he would not be able to grow his agricultural commodities.

Taxpayer provided thorough documentation to support his contentions.

There is no question that it is necessary and essential for Taxpayer to prevent encroachment of trees onto his tillable land. However, the relevant question is whether the rotary cutter (and consequently the demolition kit) has an "immediate effect" on the commodities Taxpayer grows on his land. The exemption statute sets out a "double-direct" test with the Indiana legislature having emphasized that – in order to obtain the exemption – the equipment at issue must have "an immediate effect on the article being produced." [45 IAC 2.2-5-6\(c\)](#). The work and equipment used to stop the encroachment onto tillable land is one step removed from the integrated process that produces Taxpayer's crops. As [45 IAC 2.2-5-4\(e\)](#) states, "[t]he fact that a piece of equipment is convenient, necessary, or essential to farming is insufficient in itself to determine if it is used directly in direct production as required to be exempt."

In this instance, the rotary cutter and demolition kit do not have an immediate and direct effect on the crops Taxpayer grows. Especially in light of the fact that tax exemptions are strictly construed, Taxpayer's protest is denied.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration – Ten Percent Negligence Penalty.

DISCUSSION

Taxpayer also protested 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. 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 affirmatively established, as required by [45 IAC 15-11-2\(c\)](#), that his failure to pay sales tax on the purchase of the contested equipment was due to reasonable cause and not due to negligence.

FINDING

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

SUMMARY

Taxpayer is respectfully denied on its protest of the assessment of use tax on the tangible personal property at issue; however, Taxpayer is sustained on its protest of the assessment of penalty.

Posted: 07/30/2014 by Legislative Services Agency
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