DEPARTMENT OF STATE REVENUE

04-20181196.SLOF

Supplemental Letter of Findings: 04-20181196
Sales and Use Tax
For The Tax Years 2011-13

NOTICE: IC § 4-22-7-7 permits the publication of this document in the Indiana Register. The publication of this document provides the general public with information about the Indiana Department of Revenue's official position concerning a specific set of facts and issues. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Supplemental Letter of Findings.

HOLDING

Business was able to establish that some items previously determined to be subject to sales and use taxes were actually exempt purchases. Therefore, the Department's calculations of use tax due from and refund due to Business will be recalculated. Both Business' refund claim and the assessments will be adjusted.

ISSUES

I. Sales and Use Tax–Exempt Purchases.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-5-40; IC § 6-8.1-5-1; IC § 6-8.1-5-2; IC § 6-8.1-5-3; *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Aztec Partners, LLC v. Indiana Dept. of State Revenue*, 35 N.E.3d 320 (Ind. Tax 2015); 45 IAC 2.2-3-4; 45 IAC 2.2-4-26; 45 IAC 2.2-5-8; 45 IAC 2.2-5-9; 45 IAC 2.2-5-14; *Blacks Law Dictionary* (10th ed. 2014); Sales Tax Information Bulletin 2 (March 2013) 20130327 Ind. Reg. 045130126NRA; LOF 04-20170916.

Taxpayer protests the Department's calculation of sales and use taxes refunded and use tax due.

II. Tax Administration–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 out-of-state business with Indiana operations. Taxpayer filed a claim for refund covering the tax year 2011. After reviewing the refund claim, the Indiana Department of Revenue ("Department") conducted a refund investigation of 2011 and an assessment investigation of 2012, and 2013. The Department determined that Taxpayer had made taxable purchases of tangible personal property ("TPP") during these years without paying sales tax or use tax on those purchases. The statute of limitations for assessing tax for 2011 had expired by the time of the investigation and so the results of the Department's investigation were applied to offset the claimed refund for 2011. For 2012 and 2013, the results of the investigation were applied to calculate proposed assessments of use tax. Due to the large number of transactions, the Department used a sample and projection methodology to calculate Taxpayer's use tax compliance rate for refund purposes and another sample and projection calculation for assessment purposes. Capital asset purchases were reviewed separately and as a whole, without sampling. The Department then applied the compliance rates to Taxpayer's total purchases, while deducting the amount of use tax already remitted by Taxpayer for those years. The Department therefore reduced the amount of refund for 2011 and issued proposed assessments for use tax, penalties, and interest for 2012 and 2013. Taxpayer protested that some of the TPP purchases considered taxable by the Department were actually exempt and that the Department had under-calculated the refund for 2011 and had over-calculated the amount of use tax due for 2012 and 2013.

An administrative hearing was held and the Department issued a Letter of Findings ("LOF 04-20170916") sustaining Taxpayer's protest in part and denying Taxpayer's protest in part. Taxpayer filed a request for rehearing arguing that several items ruled as taxable in LOF 04-20170916 were exempt. Taxpayer provided additional documentation and analysis in support of the rehearing request. The Department granted the request and an administrative rehearing was held. This Supplemental Letter of Findings results. Since Taxpayer's protest

was partially sustained in LOF 04-20170916, this Supplemental Letter of Findings will not discuss those items already found to be exempt. Rather, this Supplemental Letter of Findings will only discuss protested items found to be taxable in LOF 04-20170916. Further facts will be supplied as required.

I. Sales and Use Tax–Exempt Purchases.

DISCUSSION

Taxpayer protests that the Department erred in its investigation and in LOF 04-20170916 when it determined that several categories of TPP which Taxpayer purchased in the years 2011-13 were subject to sales and use taxes. The Department considered that the TPP was not used in any exempt manner and therefore sales tax should have been paid at the time of purchase or use tax should have been remitted if sales tax was not paid at the time of purchase. Taxpayer argues that many of the items of TPP which the Department considered taxable were actually eligible for one or more exemptions from sales tax and use tax. In the course of the rehearing process, Taxpayer reiterated its original position regarding these purchases and also provided further analysis and supporting documentation of how the TPP was used.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[w]hen [courts] examine a statute that an agency is 'charged with enforcing. . .[courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

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.

Use tax is imposed by IC § 6-2.5-3-2(a), which states:

> 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 used, stored, or consumed in Indiana, use tax is due unless sales tax was paid at the time of the transaction or unless the transaction is exempt from taxation in some manner.

One exemption is found under IC § 6-2.5-5-3(b), which states:

> 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.

Also, 45 IAC 2.2-5-8(h) states:

> 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.
(*Emphasis added*).

Taxpayer's first point of protest is that, while the Department sustained Taxpayer's protest that welders were exempt production machinery, the Department did not sustain Taxpayer's protest that wire feeders and repair parts for wire feeders were exempt. In the course of the rehearing process, Taxpayer was able to provide additional documentation and analysis in support of its position that the wire feeders and repair parts qualified for the exemption provided by IC § 6-2.5-5-3(b).

The Indiana Tax Court stated in *Aztec Partners, LLC v. Indiana Dept. of State Revenue*, 35 N.E.3d 320 (Ind. Tax 2015):

> Second, the Indiana Supreme Court has explained that equipment used in an integrated production process, like the consumption of the electricity here, must be essential and integral to that process, not directly transformational. *See Cave Stone,* 457 N.E.2d at 524 (finding that even though the taxpayer's equipment did not transform its property, the equipment was essential and integral to the process of transformation because no marketable product would have resulted without it). "Often, this determination is made by identifying the points where production begins and where it ends." *Indianapolis Fruit,* 691 N.E.2d at 1384 (*citing General Motors,* 578 N.E.2d at 404). *See also, e.g., Wendt LLP v. Indiana Dep't of State Revenue,* 977 N.E.2d 480, 483-88 (Ind. Tax Ct. 2012) (identifying the beginning and end of a taxpayer's public transportation process to determine whether the taxpayer's use of property was necessary and integral to that process). Accordingly, Aztec did not need to show that the electricity had a transformational effect on the food items to demonstrate that the electricity was essential and integral to Aztec's integrated production process.

Also, *Blacks Law Dictionary* (10th ed. 2014) provides:

> 1. The act of putting something away for future use; esp., the keeping or placing of articles in a place of safekeeping, such as a warehouse or depository <the storage of literary archives>. 2. The quality, state, or condition of having been put away for future use <books in storage>. 3. Space for keeping goods safe for future use or consumption; esp., a storehouse <5,000 square feet in storage>. 4. The price or amount charged for keeping goods safe for future use or consumption <$650 per month in storage>. 5. The means by which information is kept in digital form <data storage>.

The Department considered that the wire feeders actually served as storage devices for the wire until pulled out for use in the welders. As a result of the protest process, Taxpayer has established that when placed in the wire feeders, the wire had not been put away for future use, as "storage" is defined in *Blacks*. Rather, the wire feeders worked in conjunction with the welders in an integrated production process. The fact that the wire feeders did not directly have a transformational effect on Taxpayer's products is not determinative, as provided by the court in *Aztec Partners*. Therefore, the wire feeders did qualify as production equipment and were exempt from tax, as provided by IC § 6-2.5-5-3(b). Also, repair parts for exempt equipment are exempt as provided by 45 IAC 2.2-5-8(h). Taxpayer has met the burden imposed under IC § 6-8.1-5-1(c) of proving this portion of the proposed assessments wrong.

Taxpayer's next point of protest is in regard to other machinery which Taxpayer states is used in the direct production of its product. The other machinery was listed as: chillers, slag pans, Fronius plasma cutters, CD & PD drive controls for benders, control panels for production machinery, & equipment, software to operate production machinery & equipment, weld mandrel and flanger lines, turntables, robotic welders with pedestals added, de-stackers, laser etchers, spin form machines, trim machines, Weil tube former machines, other machinery and equipment, and repair parts for the aforementioned TPP. Using the same analysis as discussed above for the wire feeders under IC § 6-2.5-5-3(b) in LOF 04-20170916, the Department was not convinced that Taxpayer had established that the various pieces of machinery were used in an exempt manner.

Further, 45 IAC 2.2-5-8 provides in relevant parts:

(a) In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. The exemption provided in this regulation *[45 IAC 2.2]* extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.

(b) The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property.

(c) The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they 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 tangible personal property.

--EXAMPLES--

(1) Aluminum pistons are produced in a manufacturing process that begins, after the removal of raw aluminum from storage inside the plant, with the melting of the raw aluminum and the production of castings in the foundry; continues with the machining of the casting and the plating and surface treatment of the piston; and ends prior to the transportation of the completed pistons to a storage area for subsequent shipment to customers. Because of the functional interrelationship of the various steps and the flow of the work-in-process, the total production process, comprised of such activities, is integrated.

(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.

. . .

(E) *A work bench used in conjunction with a work station or which supports production machinery within the production process*.

. . .

(3) *The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt*. The fact that such equipment is built in a manner to service various pieces of exempt equipment, as an alternative to building the equipment into each of the pieces of exempt machinery, is not determinative.

. . .

(B) *Cooling towers and related pumps and piping used to cool, circulate, and supply water employed to control the temperature of exempt furnaces and exempt machines used in the foundry and machining areas*.

. . .

(5) A computer is used to control and monitor various aspects of the plating and surface-treatment operations in Example (1). The computer is located in a separate room in a different part of the plant from the plating and surface-treatment operations but is connected to the equipment comprising those operations by means of electrical devices. The computer equipment, including related terminals, printer, and memory, data storage, and input/output devices, is exempt because its use in this manner is an integral and essential part of the integrated production process.

. . .

(g) "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*.

--EXAMPLES--

. . .
(3) *The manufacturer of certain extruded rubber products uses an interconnected production process of an air compressor, an air dryer, and injection molding machines which work together to force rubber through dies in order to form the desired shapes. The component parts of the production process are exempt since the production process has an immediate effect upon the article being produced*.
. . .
(6) *Computers which are interconnected with and control other production machinery or are used to make tapes which control computerized production machinery are exempt from tax*.
. . .

(h) 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.

. . .
(k) "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.
. . . .

(*Emphasis added*).

After review of the analysis and supporting documentation (including written descriptions, photographs, and video of these items in operation) provided in the hearing and rehearing process, the Department now agrees with Taxpayer's protest that most of the pieces of TPP listed above qualify for the manufacturing exemption listed under IC § 6-2.5-5-3(b) and 45 IAC 2.2-5-8. The only categories listed above with which the Department does not agree are exempt are the slag pans, the "other machinery and equipment," and the spare/replacement parts for those two categories.

The Department notes that the slag pans, while physically attached to the exempt welding machines, are separately-purchased TPP and do not directly contribute to Taxpayer's direct production of its product. As provided by 45 IAC 2.2-5-8(k), "Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance as a business of an integrated series of operations which places TPP in a form, composition, or character different from that in which it was acquired. The slag pans catch excess material from the welding process, but are not integrated into Taxpayer's series of operations which places TPP in a different form, composition, or character than that in which it was acquired. Therefore, the slag pans are taxable.

With regard to the "other machinery and equipment," the Department is not convinced that this area is specific enough to determine how the TPP is used. Without confirmation of the nature of the TPP and its use, the Department cannot agree that it qualifies for the exemption listed under IC § 6-2.5-5-3(b) and 45 IAC 2.2-5-8. Therefore, these items will be considered subject to sales and use tax as determined in the audit and in LOF 04-20170916.

Taxpayer's next point of protest concerns TPP it claims was used for safety purposes. The relevant exemption is found at 45 IAC 2.2-5-8(c), which states in relevant part(s):

The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be *directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process*; i.e., they 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 tangible personal property.

-EXAMPLES-

(1) Aluminum pistons are produced in a manufacturing process that begins, after the removal of raw aluminum from storage inside the plant, with the melting of the raw aluminum and the production of castings in the foundry; continues with the machining of the casting and the plating and surface treatment of the piston; and ends prior to the transportation of the completed pistons to a storage area for subsequent shipment to customers. Because of the functional interrelationship of the various steps and the flow of the work-in-process, the total production process, comprised of such activities, is integrated.

(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*.

. . .

(E) A work bench used in conjunction with a work station or which supports production machinery within the production process.

(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*.

. . .

(g) "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.

--EXAMPLES--

(1) The manufacturing equipment utilized for the production of plastics consists of an interconnected system which contains among its components a coal fueled boiler, heat exchangers, vacuum jets, process heating vessels, distillation/stripping columns, related equipment, and piping. All elements of this integrated production process are exempt from tax.

(2) Steam generators used to heat water which is used in mixing and warming component materials in the manufacture of ready-mixed concrete are exempt from tax.

(3) The manufacturer of certain extruded rubber products uses an interconnected production process of an air compressor, an air dryer, and injection molding machines which work together to force rubber through dies in order to form the desired shapes. The component parts of the production process are exempt since the production process has an immediate effect upon the article being produced.

(4) Equipment which constitutes an essential and integral part of the integrated process is exempt. The fact that such equipment is built in a manner to service various pieces of exempt equipment, as an alternative to building the equipment into each of the pieces of exempt machinery, is not determinative.

The production of flat-rolled metal products requires that an oil mixture, which serves as both a rolling lubricant and a coolant, be continuously sprayed on sheets in the rolling mill. Spent oil is simultaneously removed and passed through a filtering process which is interconnected with the rolling mill, after which the oil is resprayed onto the sheets. The rolling mill and oil filtration process are exempt.

(5) A metal manufacturer uses a variety of electrically-powered production equipment which has differing voltage and power requirements. Power cables used to bring electricity to the manufacturer's plant are taxable. Switch gears, transformers, conduits, cables, controls, rectifiers, and generators which are interconnected with the production equipment and serve as an electrical distribution system for such equipment are exempt from tax. Items used to distribute electricity for general lighting and space heating are taxable.

(6) Computers which are interconnected with and control other production machinery or are used to make tapes which control computerized production machinery are exempt from tax.
(*Emphasis Added*).

In LOF 04-20170916, the Department sustained Taxpayer's protest regarding some of the claimed safety equipment. However, LOF 04-20170916 denied Taxpayer's protest regarding the two categories of "fencing" and "guarding" which Taxpayer claimed were exempt as safety equipment. The Department determined that Taxpayer had not established that all of the TPP listed in these categories were required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production, as provided by 45 IAC 2.2-5-8(c). After review of the analysis and supporting documentation provided in the hearing and rehearing process, the Department agrees with Taxpayer's protest regarding the fencing and guarding TPP. The items reviewed in the rehearing process served no other purpose than to prevent injury to Taxpayer's workers in the course of producing Taxpayer's product. Therefore, the Department now agrees that the fencing and guarding TPP was used in an exempt manner as provided by 45 IAC 2.2-5-8(c).

Taxpayer's next point of protest concerns material handling equipment. Taxpayer protests that the various items of TPP, such as conveyors, racks, cranes, de-stackers, and certain tables used in a continuous production process, qualify for the exemption found at 45 IAC 2.2-5-8(d), which provides:

(d) 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.

--EXAMPLE--

(1) The production of pharmaceutical items is accomplished by a process which begins with weighing and measuring out appropriate ingredients, continues with combining and otherwise treating the ingredients, and ends with packaging the items. Equipment used to transport raw materials to the manufacturing plant is employed prior to the first operation or activity constituting part of the integrated production process and is taxable. *Weighing and measuring equipment and all equipment used as an essential and integral part of the subsequent manufacturing steps, through packaging, qualify for exemption*. Equipment which loads packaged products from the packaging step of production into storage, or from storage into delivery vehicles, is subject to tax.
(*Emphasis added*).

The Department's investigation and LOF 04-20170916 both determined that Taxpayer had not provided sufficient documentation and analysis of the use of these pieces of TPP to establish that they were used in an exempt manner. In the course of the rehearing process, Taxpayer was able to provide additional analysis and documentation to establish that the TPP in question was used in an integrated production process to either transport or temporarily store work-in-process. Therefore, the material handling equipment under protest qualifies for the exemption provided under 45 IAC 2.2-5-8(d).

Taxpayer's next point of protest concerns plastic containers, knock-down totes, blue totes, shelving, and heavy duty totes. Taxpayer protests that these categories of TPP were used to temporarily store, transport, or handle work-in-process. Such use, Taxpayer argues, qualifies for the exemption found under IC § 6-2.5-5-3(b) and 45 IAC 2.2-5-8. Further, Taxpayer states that it agrees that the TPP in question is not exclusively used in an exempt manner. Taxpayer provided documentation and analysis supporting its position that the TPP found under these categories were used fifty percent of the time in an exempt manner. After review of the documentation and analysis provided in the rehearing process, the Department agrees that these purchases qualify as fifty percent exempt.

Taxpayer's next point of protest concerns forklifts. The Department determined that Taxpayer used its forklifts in a fifty-five percent taxable manner and forty-five percent exempt manner. In the course of the hearing and rehearing process, Taxpayer provided a forklift usage study in which Taxpayer determined that its forklifts were used in a 65.26 percent exempt manner. 45 IAC 2.2-5-8(f) provides in relevant part:

(f) Transportation equipment.

(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.

--EXAMPLES--

(1) A manufacturer of clay pipe uses forklift tractors to transport the pipe from the machine in which it is formed to the kiln. The forklift tractors are exempt.

(2) A metal and alloy manufacturer pulverizes raw materials for use in an exempt furnace. Weigh bins are utilized for the temporary storage of the exempt materials after pulverization and prior to use in an exempt furnace. Transportation equipment used to transport the pulverized raw material to and from the weigh bins is exempt.

(3) A forklift is used exclusively to move work-in-process from a temporary storage area in a plant and to transport it to a production machine for processing. Because the forklift functions as an integral part of the integrated system comprising the production operations, it is exempt.

(4) A forklift is used exclusively to move finished goods from a storage warehouse and to load them on trucks for shipment to customers. The forklift is taxable because it is used outside the integrated production process.

(5) A forklift is regularly used 40[percent] of the time for the purpose described in Example (3) and 60[percent] of the time for the purpose described in Example (4). The taxpayer is entitled to an exemption equal to 40[percent] of the gross retail income attributable to the transaction in which the forklift was purchased.

. . . .

Therefore, when forklifts are used for both taxable and non-taxable purposes, forklifts may be partially taxable and partially non-taxable. In the instant case, Taxpayer's forklift study has addressed the Department's initial concerns regarding some uses of the forklifts and the Department now accepts that the forklifts and forklift-associated purchases are used in a 65.26 percent non-taxable manner.

Taxpayer's next protest point is in regard to strapping equipment. LOF 04-20170916 had previously sustained Taxpayer's protest regarding poly strapping materials, but not on the strapping equipment, as provided by 45 IAC 2.2-5-8(d) and 45 IAC 2.2-5-9(d). Taxpayer states that some of the strapping was used to move unfinished parts mid-production and that the strapping machines were therefore used as part of the integrated production process. However, in LOF 04-20170916 the Department explained that it did not agree that the strapping machinery qualified as production machinery since it did not have an immediate effect upon the article being produced, as required under 45 IAC 2.2-5-8(g). Also, the shipping materials exemption found under 45 IAC 2.2-5-9(d) specifically applies to materials used in shipping and not to the machinery used in wrapping, strapping, or otherwise preparing for shipping. In the course of the rehearing process, the Department reviewed all materials provided in support of Taxpayer's position. The Department is not convinced that the documentation supports Taxpayer's protest on this point. Therefore, the strapping machinery is taxable.

Taxpayer's next protest point is in regard to labels and label makers. In the course of the rehearing process, Taxpayer provided documentation and analysis to support its position that it prints and applies labels to various items throughout its production process and that ten percent of those labels are attached to its product as part of the final product for use by consumers. Taxpayer therefore believes that the labels and label makers should qualify for a ten percent exemption rate. The relevant regulation is 45 IAC 2.2-5-14(d), which states:

(d) The purchase of tangible personal property which is to be incorporated by the purchaser as a material or an integral part is exempt from tax. "Incorporated as a material or an integral part into tangible personal property for sale by such purchaser" means:
(1) That the material must be physically incorporated into and become a component of the finished

product;
(2) The material must constitute a material or an integral part of the finished product; and
(3) The tangible personal property must be produced for sale by the purchaser.

After review of the analysis and documentation provided in the rehearing process, the Department agrees that ten percent of the labels are used in an exempt manner as provided under 45 IAC 2.2-5-14(d). Therefore, Taxpayer's purchases of labels and label makers, plus related costs such as ink, ribbons, etc., for the label makers are ten percent exempt and ninety percent taxable.

Taxpayer's next protest point is in regard to research and development ("R&D") TPP. Taxpayer states that it conducted R&D activities in which it used TPP. The relevant statute is IC § 6-2.5-5-40, which states:

(a) As used in this section, "research and development activities" includes design, refinement, and testing of prototypes of new or improved commercial products before sales have begun for the purpose of determining facts, theories, or principles, or for the purpose of increasing scientific knowledge that may lead to new or enhanced products. The term does not include any of the following:
(1) Efficiency surveys.
(2) Management studies.
(3) Consumer surveys.
(4) Economic surveys.
(5) Advertising or promotions.
(6) Research in connection with nontechnical activities, including literary, historical, social sciences, economics, humanities, psychology, or similar projects.
(7) Testing for purposes of quality control.
(8) Market and sales research.
(9) Product market testing, including product testing by product consumers or through consumer surveys for evaluation of consumer product performance or consumer product usability.
(10) The acquisition, investigation, or evaluation of another's patent, model, process, or product for the purpose of investigating or evaluating the value of a potential investment.
(11) The providing of sales services or any other service, whether technical or nontechnical in nature.
(b) As used in this section, "research and development equipment" means tangible personal property that:
(1) consists of or is a combination of:
(A) laboratory equipment;
(B) computers;
(C) computer software;
(D) telecommunications equipment; or
(E) testing equipment;
(2) has not previously been used in Indiana for any purpose; and
(3) is acquired by the purchaser for the purpose of research and development activities devoted directly to experimental or laboratory research and development for:
(A) new products;
(B) new uses of existing products; or
(C) improving or testing existing products.
(c) As used in this section, "research and development property" means tangible personal property that:
(1) has not previously been used in Indiana for any purpose; and
(2) is acquired by the purchaser for the purpose of research and development activities devoted to experimental or laboratory research and development for:
(A) new products;
(B) new uses of existing products; or
(C) improving or testing existing products.
(d) For purposes of subsection (c)(2), a research and development activity is devoted to experimental or laboratory research and development if the activity is considered essential and integral to experimental or laboratory research and development. The term does not include activities incidental to experimental or laboratory research and development.
(e) For purposes of subsection (c)(2), an activity is not considered to be devoted to experimental or laboratory research and development if the activity involves:
(1) heating, cooling, or illumination of office buildings;
(2) capital improvements to real property;
(3) janitorial services;
(4) personnel services or accommodations;
(5) inventory control functions;

(6) management or supervisory functions;
(7) marketing;
(8) training;
(9) accounting or similar administrative functions; or
(10) any other function that is incidental to experimental or laboratory research and development.

(f) A retail transaction:
(1) involving research and development equipment; and
(2) occurring after June 30, 2007, and before July 1, 2013; is exempt from the state gross retail tax.

(g) A retail transaction:
(1) involving research and development property; and
(2) occurring after June 30, 2013; is exempt from the state gross retail tax.

(h) The exemption provided by subsection (g) applies regardless of whether the person that acquires the research and development property is a manufacturer or seller of the new or existing products specified in subsection (c)(2).

(i) For purposes of this section, a retail transaction shall be considered as having occurred after June 30, 2013, to the extent that delivery of the property constituting selling at retail is made after that date to the purchaser or to the place of delivery designated by the purchaser. However, a transaction shall be considered as having occurred before July 1, 2013, to the extent that the agreement of the parties to the transaction is entered into before July 1, 2013, and payment for the property furnished in the transaction is made before July 1, 2013, notwithstanding the delivery of the property after June 30, 2013. This subsection expires January 1, 2017.

Therefore, IC § 6-2.5-5-40 provides that purchases were exempt from sales and use taxes if specific conditions were met. The Department notes that IC § 6-2.5-5-40 was amended effective July 1, 2013, to reflect that TPP at issue for the R&D exemption no longer needed to have a useful life of less than one year. LOF 04-20170916 denied Taxpayer's protest on the basis that Taxpayer had not established that its activities qualified for the R&D exemption provided under IC § 6-2.5-5-40. In the course of the rehearing process, Taxpayer provided additional documentation and analysis in support of its claim. After review of these materials, the Department agrees with Taxpayer's protest regarding TPP listed as eligible for the R&D exemption, as provided under both versions of IC § 6-2.5-5-40 in effect during the audit period.

Taxpayer's next point of protest is in regard to testing equipment. Taxpayer states that it purchased TPP such as camera systems, tensile testers, torque testers, and other machinery and equipment used to test its products. The relevant regulation is 45 IAC 2.2-5-8(i), which states:

(i) Testing and inspection. *Machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt*.

--EXAMPLE--

Selected parts are removed from production according to a schedule dictated by statistical sampling methods. Quality control equipment is used to test the parts in a room in the plant separate from the production line. *Because of the functional interrelationship between the testing equipment and the machinery on the production line and because of the product flow, the testing equipment is an integral part of the integrated production process and is exempt*.
(*Emphasis added*).

LOF 04-20170916 denied Taxpayer's protest on this point on the basis that it was not possible to tell if the camera systems, tensile testers, torque testers were used in an integrated production process. In the course of the rehearing process, Taxpayer provided additional documentation and analysis in support of its protest. After review of these materials, Taxpayer was able to establish that the TPP in question was used as part of Taxpayer's quality control in the production process. Therefore, the Department agrees that the camera systems, tensile testers, torque testers were used as part of an integrated production process and therefore qualified for the exemption described under 45 IAC 2.2-5-8(i). Regarding the other machinery and equipment listed under this protest category, the Department remains unconvinced that the documentation and analysis establishes the exempt nature of this portion of the TPP under protest.

Taxpayer's next point of protest is in regard to the statute of limitations for imposing an assessment. Taxpayer argues that the Department was not allowed to make a determination of the taxable status of several purchases which took place in 2010, but which were capitalized in 2011, which was the year of the refund claim. The Department determined that the purchases were taxable and offset the refund claim by the corresponding amount

of tax for those transactions. IC § 6-8.1-5-2(a) states:

> (a) Except as otherwise provided in this section, the department may not issue a proposed assessment under section 1 of this chapter more than three (3) years after the latest of the date the return is filed, or either of the following:
> (1) The due date of the return.
> (2) In the case of a return filed for the state gross retail or use tax, the gasoline tax, the special fuel tax, the motor carrier fuel tax, the oil inspection fee, or the petroleum severance tax, the end of the calendar year which contains the taxable period for which the return is filed.

LOF 04-20170916 determined that the offset of refund did not constitute an assessment of tax and denied the protest. In the course of the rehearing process, Taxpayer did not present new documentation or analysis regarding this issue. After reviewing the previously presented arguments and documentation, the Department does not change its decision. Offsetting a tax refund claim is not the same thing as assessing tax, therefore the three year statute of limitations established under IC § 6-8.1-5-2(a) does not apply here.

Taxpayer's next point of protest is in regard to electrical work done as an improvement to realty by a contractor under a lump-sum agreement. The Department offset the refund claim for 2011 by the amount of two such transactions. LOF 04-20170916 sustained Taxpayer's protest on one such transaction, determining that Taxpayer had met the requirements of IC § 6-2.5-3-2, which states:

> (c) The use tax is imposed on a contractor's conversion of construction material into real property if that construction material was purchased by the contractor. However, the use tax does not apply to conversions of construction material described in this subsection, if:
> (1) the state gross retail or use tax has been previously imposed on the contractor's acquisition or use of that construction material;
> (2) the person for whom the construction material is being converted could have purchased the material exempt from the state gross retail and use taxes, as evidenced by a properly issued exemption certificate, if that person had directly purchased the construction material from a retail merchant in a retail transaction; or
> (3) the conversion of the construction material into real property is governed by a time and material contract as described in IC 6-2.5-4-9(b).

Also, 45 IAC 2.2-4-26(a) states:

> A person making a contract for the improvement to real estate whereby the material becoming a part of the improvement and the labor are quoted as one price is liable for the payment of sales tax on the purchase price of all material so used.

However, the Department denied Taxpayer's protest regarding a second such transaction. The Department determined that the contractor's own description of the transaction did not support Taxpayer's argument that the exemption applies to the second transaction. In the course of the rehearing process, the Department reviewed the documentation and analysis and now reaches the same conclusion as it did in LOF 04-20170916 regarding the second transaction. Taxpayer also states that the Department was barred from making such an adjustment by the three year statute of limitations found under IC § 6-8.1-5-2(a). As discussed above, IC § 6-8.1-5-2(a) does not apply to refund offsets.

Taxpayer's final point of protest is in regard to maintenance contracts. Taxpayer protests that the Department imposed use tax denied refund of sales and use taxes on the purchase of maintenance agreements which were for consultation only, with no provision for the transfer of TPP. Sales Tax Information Bulletin 2 (March 2013) 20130327 Ind. Reg. 045130126NRA provides:

> Maintenance contracts generally meet the definition of bundled transactions under IC 6-2.5-1-11.5 and are subject to sales tax on that basis. The determination as to whether a contract is a maintenance contract is not necessarily based on the particular title of or language used in the contract. Instead, the determination is based on the substantive provisions contained in the contract. An explicit guarantee that tangible personal property will be provided under the contract is not required. What is important is that both the customer and the service provider are aware at the time the contract is executed that consumable items will be provided under the contract. However, the amount of tangible personal property supplied under the contract must be more than a de minimis amount. As a rule, the seller's purchase price or the sales price of the taxable items provided under the contracts must exceed 10[percent] of the total purchase price or the total sales price of

the bundled products.

In the instant case, Taxpayer provided documentation and analysis that establishes that the maintenance agreements in question was for consultation only. Since no transfer of TPP would occur under the agreements, no sales or use tax is due as explained in Sales Tax Information Bulletin 2.

In conclusion, Taxpayer is sustained in part or in whole on its protest of several categories as provided above. Also, Taxpayer was sustained on several categories in LOF 04-20170916, subject to audit verification. Therefore, the Department will reclassify these transactions upon which Taxpayer has been sustained as non-taxable, for both capital and expensed purchases, and will recalculate Taxpayer's compliance rates for both the claimed refund and for assessments. The Department will then apply the recalculated compliance rates and its calculations regarding capital purchases and will recalculate the amount of refund due for 2011 and the amount of the assessments for 2012 and 2013.

FINDING

Taxpayer's protest is sustained in part and denied in part, as provided above.

II. Tax Administration–Penalty.

DISCUSSION

Taxpayer requested that the Department abate the negligence penalty imposed regarding the assessments of use tax for 2012 and 2013. Pursuant to IC § 6-8.1-10-2.1(a), the Department may assess a negligence penalty if the taxpayer:

(1) fails to file a return for any of the listed taxes;
(2) fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment;
(3) incurs, upon examination by the department, a deficiency that is due to negligence;
(4) fails to timely remit any tax held in trust for the state; or
(5) is required to make a payment by electronic funds transfer (as defined in IC 4-8.1-2-7), overnight courier, or personal delivery and the payment is not received by the department by the due date in funds acceptable to the department.
(*Emphasis added*).

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 when a taxpayer establishes that its failure to pay a tax was due to reasonable cause and not due to negligence. 45 IAC 15-11-2(c). The taxpayer must demonstrate that it exercised ordinary business care in carrying out or failing to carry out a duty giving rise to the penalty. Reasonable cause is fact sensitive and will vary based on the facts of each individual case.

In this instance, Taxpayer has been sustained in part and denied in part regarding the amount of base tax due, as provided in Issue I above. Since Taxpayer will still owe a significant amount of use tax based on several areas of the purchase of TPP, the Department cannot agree that Taxpayer has demonstrated that it exercised ordinary business care in carrying out its tax duties, as required by 45 IAC 15-11-2(c). Therefore, penalty will not be waived. However, since the base tax will be reduced, as provided in Issue I above, penalty will be recalculated to reflect that reduced amount of use tax due.

FINDING

Taxpayer's protest of the negligence penalty is denied.

SUMMARY

Taxpayer is sustained in part and denied in part on Issue I regarding the imposition of use tax. Taxpayer is denied on Issue II regarding the imposition of penalty.

October 16, 2018.

Posted: 12/26/2018 by Legislative Services Agency
An html version of this document.