DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 99-0404
Indiana Sales and Use Tax
For the Tax Years 1995, 1996, and 1997

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ISSUES

I. Production Equipment.

Authority: IC 6-2.5-1-1 et seq.; IC 6-2.5-5-3(b); Indiana Dept. of State Revenue v. Cave Stone, 457 N.E.2d 520 (Ind. 1983); Mumma Bros. Drilling Co. v. Dept. of Revenue, 411 N.E.2d 676 (Ind. Ct. App. 1980); General Motors Corp. v. Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(g).

Taxpayer maintains that certain items of equipment, attached to its production machinery and used to service and maintain that machinery, are entitled to the production exemption.

II. Material Handling Equipment.

Authority: IC 6-2.5-5-3(b); 45 IAC 2.2-5-8(d); 45 IAC 2.2-5-10(c)(2)(D).

Taxpayer argues that equipment used in handling and packaging its completed plastic bottles is entitled to the manufacturing exemption because the packaging of the bottles occurs within its direct production activities.

III. Air-Conditioning Equipment.

Authority: IC 6-2.5-5-3(b); Indiana Dept. of State Revenue v. Cave Stone, 457 N.E.2d 520 (Ind. 1983); Dept. of State Revenue v. Kimball International, Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Ind. Dept. of Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974).

According to taxpayer, the air conditioning equipment used to maintain temperature and humidity levels inside of its production plant, is directly involved in the direct production of its tangible personal property and is exempt from sales and use tax.

IV. Storage Silos.

Authority: 45 IAC 2.2-3-9(e)(3); 45 IAC 2.2-3-12(c); 45 IAC 2.2-5-8(e); 50 IAC 2.2-1-3.

Taxpayer disagrees with the audit's conclusion that its storage silos were "storage equipment" subject to use tax. According to taxpayer, the storage silos are actually improvements to "real property" exempt from the gross retail tax.

V. Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer argues that the imposition of the ten-percent negligence penalty was incorrect and that the Department is required to abate the penalty.

STATEMENT OF FACTS

Taxpayer produces empty plastic bottles by injection molding. The empty plastic bottles are then sold to other manufacturers which use them for packaging various consumer products. Taxpayer's production facility is located within the state. The Department conducted an audit which resulted in the assessment of additional sales and use tax. Taxpayer disagreed with a number of those assessments and submitted a protest. A number of the protested issues were resolved at the protest review stage. An administrative hearing was conducted, and this Letter of Findings results.

DISCUSSION

I. Production Equipment.

Taxpayer purchased a number of items of equipment which it uses with, or are attached to, its production machinery. These items consist of stairs, platforms, guards, ladder, and crossover steps. The audit concluded these items were not directly involved in the production of plastic bottles and assessed use tax accordingly. Taxpayer disagrees arguing that the equipment is directly involved in the production of its plastic bottles.

In Indiana, a sales tax is imposed on retail transactions, and a complementary use tax is imposed on tangible personal property that is stored, used, or consumed in the state. IC 6-2.5-1-1 et seq. In this instance, taxpayer relies on the tax exemption found at IC 6-2.5-5-3(b). That particular exemption states that: "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." (*Emphasis added*). It is taxpayer's contention that the various items of equipment fall within the definition of "direct use" as provided in 45 IAC 2.2-5-8(c). That regulation reads as follows:

> 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.

The Legislature has provided Indiana manufacturers a sales tax exemption for certain purchases of equipment directly involved in the direct production of manufactured goods. However, in enacting the stringently worded exemption, the Legislature plainly did not intend to create a global exemption for any and all equipment which a manufacture purchases for use within its manufacturing facility. The manufacturing exemption, "fairly read, is meant to exempt capital equipment that meets the 'double direct' test." Mumma Bros. Drilling Co. v. Dept. of Revenue, 411 N.E.2d 676, 678 (Ind. Ct. App. 1980). The court has held that capital equipment "in order to be exempt, (1) must be *directly* used by the purchaser and (2) be used in the *direct* production, manufacture, fabrication, assembly, extraction, mining, processing, refining or finishing of tangible personal property." Indiana Dept. of State Revenue v. Cave Stone, 457 N.E.2d 520, 525 (Ind. 1983) (*Emphasis added*). "[T]he test for directness requires the equipment to have an 'immediate link with the product being produced.'" Id. Accordingly, the sales tax exemption is applicable to that equipment which meets the "double direct" test and is "essential and integral" to the manufacture of taxpayer's tangible personal property. General Motors Corp. v. Dept. of State Revenue, 578 N.E.2d 399, 401 (Ind. Tax Ct. 1991).

Undoubtedly, the various items of equipment play a significant role in the production of taxpayer plastic bottles. However, the equipment does not have an immediate relationship to the production of the bottles, does not meet the double direct test, and is not essential and integral to the production of taxpayer's plastic bottles. As noted in 45 IAC 2.2-5-8(g), "The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required . . . by practical necessity does not itself mean that the property 'has an immediate effect upon the article being produced.'"

FINDING

Taxpayer's protest is respectfully denied.

II. Material Handling Equipment.

Taxpayer argues that the purchase of the tilt tables, pack stands, and a palletizer are exempt from the gross retail tax because these items of equipment are involved in the direct production of the plastic bottles. The pack stands are used by production workers to fill empty boxes with plastic bottles. The palletizer is used to stack the filled boxes unto a skid before the loaded skid is shrink-wrapped and banded. Taxpayer failed to precisely describe the manner in which the "tilt tables" are used; apparently, the "tilt tables" are used to assist workers in handling the packaged or partially packaged material.

The audit determined that this equipment was used to move taxpayer's finished bottles after the production process was complete and indicated that the equipment was subject to use tax.

As stated above, taxpayer is entitled to an exemption for equipment and machinery purchased "for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining,

processing, refining, or finishing of other tangible personal property." IC 6-2.5-5-3(b). Common sense and practical experience indicate that there are some activities which occur *before* a manufacturer begins producing tangible personal property and that there are some activities which occur *after* the manufacturer completes producing its tangible personal property. 45 IAC 2.2-5-8(d), entitled "Pre-production and post-production activities," defines those parameters stating that, "'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 items to its completed form, including packaging, if required."

The regulation provides specific guidance in classifying taxpayer's own equipment as either "pre-production" or "post-production." In one of the examples provided in 45 IAC 2.2-5-10(c)(2)(D), a manufacturer's "production process" concluded "with the final packaging of the product onto the case palletizers." Using the cited example as the benchmark, the Department concludes that taxpayer's own palletizer is entitled to the exemption provided under IC 6-2.5-5-3(b). In addition – using the palletizer as a reference – the Department concludes that the remaining items of equipment are entitled to this same exemption to the extent that the equipment is involved in handling the plastic bottles before arriving at the palletizer.

FINDING

Taxpayer's protest with respect to the palletizer is sustained. Taxpayer's protest with respect to the tilt tables and the pack stands is sustained to the extent that these two specific categories of equipment are used to handle the plastic bottles before reaching the palletizer.

III. Air-Conditioning Equipment.

Taxpayer purchased cooling equipment which is used to air-condition its manufacturing plant. Taxpayer argues that, because the cooling equipment is necessary for the production of its plastic bottles, its initial purchase of the cooling equipment was exempt from sales tax pursuant to IC 6-2.5-5-3(b). The audit disagreed with taxpayer's argument, found that the cooling equipment was only peripherally involved with the direct production of taxpayer's plastic bottles, and assessed additional use tax accordingly.

Taxpayer makes its bottles using raw plastic pellets. The pellets are blended, dried, melted, and then injected into molds. According to taxpayer, the molding must occur in a moisture-free environment, or unacceptable levels of condensation would accumulate on the molds.

The molding machines are enclosed in large plexiglas structures. Separate air-handling equipment supplies air to these enclosed structures. This separate air-handling equipment is not at issue; what is at issue is the primary cooling equipment used to air-condition the entire manufacturing facility. Taxpayer argues that, because doors to the plexiglas structures are opened and closed during production of the bottles, air from the plant migrates into the enclosures. According to taxpayer, unless the entire plant was air conditioned, the unconditioned plant air would contaminate the production of the plastic bottles.

Taxpayer cites to Dept. of State Revenue v. Kimball International, Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988) in support of its argument that its air conditioning equipment is entitled to the exemption. In that case, the court found that the manufacturer's air make up units were exempt because, without the air make up units, "the manufacturing process would not be possible" and because the units were "essential and integral parts of the entire manufacturing process." Id. at 457.

However, the taxpayer's plant-wide cooling equipment is not analogous to the air make up units in Kimball. In Kimball, the air make up units were used to supply conditioned air to the manufacturer's isolated paint booths. Id. at 455. There is no indication that taxpayer's plant-wide air conditioning equipment is as essential or integral to the production of the plastic bottles. Although the court noted that, "qualification for the exemption is highly fact sensitive," taxpayer's circumstances are more comparable to that of the picture tube manufacturer in Ind. Dept. of Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974). Id. 456. In that case, the court found that the picture tube manufacturer's environmental control equipment, used to maintain a plant-wide dust free environment, was not entitled to the exemption. RCA at 100. The picture tube manufacturer's air conditioning equipment was not exempt because the equipment's "immediate effect [was] on the surroundings in which the manufacturing process [took] place and only through the intervening agency of those surroundings, on the tubes or on the process by which they [were] manufactured." Id.

Taxpayer's plant-wide air conditioning equipment is not entitled to the exemption because the equipment is not directly used in the production of the plastic bottles and has no "immediate link with the product being produced." Cave Stone, 457 N.E.2d at 525.

FINDING

Taxpayer's protest is respectfully denied.

IV. Storage Silos.

Taxpayer purchased "silos" for the purpose of storing raw plastic pellets. The silos are located outside of the manufacturing plant. When the raw plastic pellets first arrive at taxpayer's facility, they are loaded into the silos. When taxpayer is ready to use the pellets, they are transferred to "surge bins," combined to achieve the desired color, and then moved to the molding machines in the production area.

The audit found that, pursuant to 45 IAC 2.2-5-8(e), the silos were not exempt and assessed use tax accordingly. The regulation states that, "Tangible personal property used in or for the purpose of storing raw materials . . . is subject to tax . . . ." There is no question that the silos are used to store taxpayer's "raw materials." According to taxpayer, what is it at issue is whether the silos are "[t]angible personal property."

The audit determined the silos were tangible personal property more similar to "equipment" then to "real property." In support of that conclusion, the audit noted that the silos were subject to

extensive wear and tear, were replaced frequently (approximately every two years), were not of a "permanent or substantial nature," and would likely be moved if the plant were ever moved.

Taxpayer argues that the silos are "real property" exempt from sales and use tax pursuant to 45 IAC 2.2-3-9(e)(3). That regulation states, in relevant part, as follows:

> With respect to construction materials a contractor acquired tax-free, the contractor is liable for the use tax and must remit such tax . . . to the Department of Revenue when he disposes of such property in the following manner . . . (3) Lump sum contract. [The contractor] converts the construction material into realty on land he does not own pursuant to a contract that includes all elements of cost in a total contract price.

In addition, taxpayer – in support of the argument that the storage silos should be classified as real property – cites to the "Real Property Assessment" of the Indiana Administrative Coe. In particular, taxpayer points to 50 IAC 2.2-1-3, which states in part that, "The use of a unit of machinery, equipment, or a structure determines its classification a Real or Personal Property. If the unit is a land or building improvement, it is considered as Real Property." Because the storage silos hold the raw materials before taxpayer's manufacturing process begins, and because no "manufacturing" occurs *within* the silos, the silos should be classified as "real property" exempt from sales and use tax.

The Department declines to accept taxpayer's conclusion that the real property regulations and the sales and use tax regulations should be read in pari materia. Although 50 IAC 2.2-1-3 provides some indication that silos – together with "grain elevators" and "cupolas – are classified as "real property," there is nothing to indicate that the IC 6-1.1 et seq. (property tax) and IC 6-2.5 et seq. (gross retail tax) are in pari materia.

Rather, the Department finds that the pellet storage silos at issue are more similar to discharge bins or storage hoppers than to "an improvement to real estate" (45 IAC 2.2-3-12(c)) or "realty on land" (45 IAC 2.2-3-9(e)(3)). Because the Department agrees with taxpayer's position that the silos are used to store its plastic pellets before the onset of production, and because the Department finds that the silos are storage equipment, the audit's assessment of additional use tax was not erroneous. Under 45 IAC 2.2-5-8(e), "Tangible personal property used in or for the purpose of storing raw materials or finished goods is subject to tax . . . ."

FINDING

Taxpayer's protest is respectfully denied.

V. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer protests imposition of the ten-percent negligence penalty. Taxpayer requests the Department to waive the penalty on the ground that the taxpayer "provided a bona fide interpretation of controlling authority for the overwhelming majority of the assessment" and because it "made a good faith attempt to self-assess use tax on all subject items."

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that 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 . . . ."

The Department finds no indication that the ten-percent negligence penalty was assessed. To the contrary, the audit specifically recommended that imposition of the penalty was unwarranted. Therefore, the taxpayer's protest as to the issue of penalties is rendered moot.

FINDING

Taxpayer's protest is denied.

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