

DEPARTMENT OF STATE REVENUE

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LETTER OF FINDINGS NUMBER: 04-950543

Sales and Use Tax

For The Period: 1991 Through 1993

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**ISSUES**

**I. Sales and Use Tax-Material-Handling Equipment**

**Authority:** IC 6-2.5-5-3, Indiana Department of Revenue v. Cave Stone, Inc., 457 N.E.2d 520, (Ind. 1983); 45 IAC 2.2-5-8(g); Department of Revenue v. Kimball International, Inc., 520 N.E.2d 454 (1988)

The taxpayer protests the imposition of sales/use tax on equipment used to transport resin through the "resin drying/injection molding system."

**II. Sales and Use Tax-Jig Washing Equipment**

**Authority:** Indiana Department of Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983); 45 IAC 2.2-5-8(h)(1)

The taxpayer protests the imposition of sales tax on equipment used to wash jigs used to mold compact disks.

**III. Sales and Use Tax-Pipe and Pipe Connectors**

**Authority:** IC 6-2.5-5-30

The taxpayer protests the imposition of sales/use tax on the purchase of canteen food and supplies where no proof of payment is available.

**IV. Sales and Use Tax - No Record of Sales Tax Payment**

**Authority:** IC 6-8.1-5-1(a)

The taxpayer protests the imposition of sales tax on foodstuffs sold in the taxpayer's facilities.

**V. Sales and Use Tax-10% Negligence Penalty**

**Authority:** LOF87-0486-ST; IC 6-8.1-10-2.1; 45 IAC 15-11-2; 45 IAC 15-11-1(b)

The taxpayer protests the imposition of a 10% negligence penalty on all assessments.

**STATEMENT OF THE FACTS**

The taxpayer is in the business of manufacturing compact disks, or digital audio disks. The manufacturing process includes mastering the audio, cutting a glass master disk, stamping a metal master from the glass master, molding volume disks, adding the reflective medium to the disks, adding a protective layer over the reflective medium, quality inspection, and labeling/packaging.

**I. Sales and Use Tax-Material Handling Equipment**

**DISCUSSION**

Discs are made from a poly-carbonate resin that is injected into a mold with a stamper in order to obtain an appropriately pitted surface. Injection molding machinery is interconnected with resin-drying and material-handling equipment. The taxpayer purchases bulk resin and stores the resin in its warehouse prior to use in production. When needed, resin bags are transported to the resin drying/injection molding system, where they are dumped into a bin, from which the resin continuously moves through feedlines into the drying hoppers, and from the drying hoppers into injection molders.

The taxpayer protests the imposition of sales tax on the material-handling equipment used in this process, including holding bins. The taxpayer contends that the holding bins are not used for pre-production storage, but are instead used in production to feed materials in the production mechanism. The taxpayer also argues that the facts underlying the material handling components of the resin drying/injection molding system are wholly indistinguishable from those in a previous Letter of Finding. In that Letter of Finding the Department sustained the taxpayer's protest of imposed tax on material-handling equipment, including holding bins.

The Supreme Court of Indiana in Department of Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (1983) stated that the property in question is to be viewed by focusing on the whole manufacturing process and deciding whether the item at issue is an essential and integral part of an integrated process (codified at 45 IAC 2.2-5-8(g)). The Indiana Court of Appeals in Department of Revenue v. Kimball International, Inc., 520 N.E.2d 454 (1988) stated that the test for whether the item plays an essential, integral role is whether the manufacturing process would be operationally impossible without such property. The auditor contends that the property at issue is taxable as pre-production property "until the resin reaches the first step of production (the drying unit)." However, the issue is not at which point the machinery transforms the resin. The court in Kimball stated that if the production process could not

proceed without the components, then the components are an essential and integral part of an integrated process pursuant to 45 IAC 2.2-5-8(g). Thus in addition to the production-continuum analysis (i.e., pre-production, production, post-production), the Court also took into account the essentiality and the integrated process of production--looking not only at each segment in the chain of production, but also the essentialness of the machinery to the production. The taxpayer has demonstrated that the material-handling equipment is indeed essential and integral to the production process, which starts with the use of this equipment.

#### **FINDING**

The taxpayer's protest is sustained.

### **II. Sales and Use Tax-Jig Washing Equipment**

#### **DISCUSSION**

Jig-washing equipment and cleaning chemicals strip excess aluminum from jigs. Jigs are used to add the reflective-layer coating to the disks. The jigs are routinely subjected to washing at specific, predetermined intervals. The production is staggered in such a fashion that the cleaning can take place without production stopping. The taxpayer contends that the jigs are unusable without routinely cleaning them, and the cleaning of the jigs is part and parcel of the production process.

The auditor points to 45 IAC 2.2-5-8(h)(1) as relevant, which states "Machinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process are subject to tax." The auditor also argues that the equipment has been held to be taxable as maintenance equipment to service the production equipment.

The taxpayer contends that the production process would cease without clean jigs, and that the cleaning equipment is an integral part of the whole process. Furthermore, the taxpayer contends that 45 IAC 2.2-8-1(h)(1) is not applicable because the equipment is not being refurbished, maintained, or repaired. Rather, it is being cleaned as part of the production process. The Department notes that any production equipment would eventually stop without proper maintenance, but this does not make such maintenance equipment essential and integral of the production process.

#### **FINDING**

The taxpayer's protest is denied.

### **III. Sales and Use Tax- Piping and Pipe Connectors**

#### **DISCUSSION**

The taxpayer also protests the imposition of sales tax on piping, pipe connectors, and the like. The auditor contends that:

While manufacturing or process equipment has been determined to be exempt, the plumbing, water drainage, sleeves, trenchwork, piping connections, etc. that are installed after the production equipment would not be exempt since the water or runoff from the production machines is not scrap or a waste product that is to be recycled, reclaimed or resold. Any conveyance that collects excess raw material or consumables that are fed into a production machine, would be taxable if the scrap or excess raw material is not to be introduced back into the cycle or sold for scrap.

The taxpayer argues that the piping is an integral part of the integrated production process. However, the Department disagrees because other means of runoff disposal could be employed, showing that the piping is not essential and integral.

The taxpayer also argues that even if the equipment is not found exempt as an essential part of the production process, it should qualify for exemption under IC 6-2.5-5-30, which states that sales of tangible personal property are exempt from the state gross retail tax if:

- (1) the property constitutes, is incorporated into, or is consumed in the operation of a device, facility, or structure predominantly used and acquired for the purpose of complying with any state, local, or federal environmental quality statutes, regulations, or standards; and
- (2) the person acquiring the property is engaged in the business of manufacturing, processing, refining, mining, or agriculture.

However, the taxpayer has not provided information showing that the piping is used specifically to comply with environmental statutes. In absence of proof that the equipment is so used, no exemption is available.

#### **FINDING**

The taxpayer's protest is denied.

### **IV. Sales and Use Tax- No Record of Sales Tax Payment**

#### **DISCUSSION**

After examining records of the taxpayer, the auditor concluded that the taxpayer was not charging sales tax on some foodstuffs sold in the taxpayer's facilities. The vendor, through a letter, has assured that tax is being remitted by the

vendor. The taxpayer has provided the Department with sample invoices covering the periods at issue in the present audit. Most of these invoices show that the vendor charged sales tax on food services. However, since there are no invoices from the assessment periods at issue, the taxpayer's protest must be denied. IC 6-8.1-5-1(b) states that, "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." The taxpayer has not sufficiently shown that the tax was previously paid.

#### **FINDING**

The taxpayer's protest is denied.

#### **V. Tax Administration - Penalty**

#### **DISCUSSION**

The taxpayer protests the imposition of a ten percent negligence penalty. Indiana Code section 6-8.1-10-2.1 requires a ten percent (10%) penalty to be imposed if the tax deficiency is due to the negligence of the taxpayer. Department regulation 45 IAC 15-11-2 provides guidance by defining negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is also determined on a case-by-case basis according to the facts and circumstances of each taxpayer.

Subsection (d) of IC 6-8.1-10-2.1 allows the penalty to be waived upon a showing that the failure to pay the deficiency was due to reasonable cause. Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish reasonable cause, the taxpayers must show that they "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed...."

The taxpayer contends that no justification of penalty was made in the audit report and that the Department has not attempted to justify the imposition of the penalty to the taxpayer and thus, no penalty should have been assessed. The taxpayer notes that the proposed assessment pertains only to use tax. The taxpayer's sales tax returns are materially correct and that there were no changes to the taxpayer's withholding tax liabilities. The taxpayer also argues, even in light of the contested issued above, only 2% of the total use tax remitted is at issue. The taxpayer contends that this reflects "an exceptional level of compliance" which should be taken into consideration.

Also, the taxpayer argues that a previous Letter of Finding--ruling that many of the currently proposed items should be found exempt--is further evidence that the taxpayer has acted in good faith and as a reasonable taxpayer.

#### **FINDING**

The taxpayer's protest is sustained.