

Supplemental Letter of Findings: 08-0577
Sales and Use Tax
For the Years 2005, 2006, and 2007

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ISSUE

I. Sales and Use Tax – Manufacturing Exemption.

Authority: IC § 6-2.5-1-1 et seq.; IC § 6-2.5-3-4; IC § 6-2.5-5-3; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-11](#); Rotation Products Corp. v. Indiana Dep't of State Revenue, 690 N.E. 2d 795 (Ind. Tax Ct. 1998); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the assessment of tax on purchases of tangible personal property.

STATEMENT OF FACTS

Taxpayer is an Indiana company that tests and recertifies used gas cylinders for its customers pursuant to federal regulatory requirements. After an audit, the Indiana Department of Revenue ("Department") concluded that Taxpayer is not a remanufacturer of the used gas cylinders and, therefore, manufacturing exemptions do not apply, resulting in additional use tax and penalty for the tax years 2005, 2006, and 2007.

Taxpayer protested the imposition of the tax and penalty. After a hearing, the Department issued Letter of Findings # 08-0577 which sustained Taxpayer's protest on penalty, but denied Taxpayer's protest on manufacturing exemptions. Taxpayer timely requested a rehearing to present additional documentation. Taxpayer's request was granted, the documentation was reviewed, and this Supplemental Letter of Findings results. Additional facts will be provided as necessary.

I. Sales and Use Tax – Manufacturing Exemption.

DISCUSSION

In the Letter of Findings # 08-0577, the Department concluded Taxpayer did not satisfy the first prong and the fourth prong of the four-part test established by Rotation Products Corp. v. Indiana Dep't of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998). Therefore, the Department concluded that Taxpayer is not a remanufacturer of the used gas cylinders and manufacturing exemptions do not apply to it. Taxpayer, to the contrary, argued that its process of testing and recertification constitutes remanufacturing cylinders and, therefore, pursuant to Indiana Code and case law, manufacturing exemptions apply to it.

All tax assessments are prima facie evidence that the Department's claim for the unpaid 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).

Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq. All purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable. [45 IAC 2.2-5-8\(a\)](#).

An exemption from 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. Additionally, in certain circumstances, exemptions from sales and use tax are available.

IC § 6-2.5-5-3(b) states:

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.

IC § 6-2.5-5-5.1(b) provides:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture.

An exemption applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. Id. Machinery, tools, and equipment are directly used in the production process if they have an immediate effect on the article being produced. [45 IAC 2.2-5-8\(c\)](#). A machine, tool, or piece of equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. Id. An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." [45 IAC 2.2-5-8\(c\)](#), Example 1.

[45 IAC 2.2-5-8\(k\)](#) describes direct production as the performance of an integrated series of operations which

transforms the matter into a form, composition or character different from that in which it was acquired, and that the change must be substantial resulting in a transformation of the property into a different and distinct product. (Emphasis added).

The exemption for direct use in production is further explained at [45 IAC 2.2-5-11](#), in part, as follows:

(a) The state gross retail tax shall not apply to sales of tangible personal property to be directly used by the purchaser in the direct production or manufacture of any manufacturing or agricultural machinery, tools, and equipment described in [IC 6-2.5-5-2](#) or 6-2.5-5-3 [[IC 6-2.5-5-3](#)].

(b) The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to tangible personal property directly used in the direct production of manufacturing or agricultural machinery, tools, and equipment to be used by such manufacturer or producer.

(c) The state gross retail tax shall not apply to purchases of tangible personal property to be directly used by the purchaser in the production or manufacturing process of any manufacturing or agricultural machinery, tools, or equipment, provided that the machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect upon the article being produced or manufactured. The 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.

(d) For the application of the rules [subsections] above, refer to Regs. 6-2.5-5-3 [[45 IAC 2.2-5-8](#) through [45 IAC 2.2-5-10](#)] with respect to tangible personal property used directly in the following activities:

pre-production and post-production activities; storage; transportation; tangible personal property which has an immediate effect upon the article produced; maintenance and replacement; testing and inspection; and managerial, sales, and other nonoperational activities.

[45 IAC 2.2-5-8](#)(d) states:

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.

Before Taxpayer can benefit from the exemption stated above, Taxpayer must meet the threshold question of whether Taxpayer's activities qualify as a manufacturing process. The court in *Rotation Products* illustrated that a taxpayer can be considered a remanufacturer if the taxpayer's repair activity was directly involved in the creation of a product. *Rotation Products*, 690 N.E.2d at 799. The *Rotation Products* court established a four-part test of determining what repair activity might rise to the level of remanufacturing, as follows:

- 1) The substantiality and complexity of the work done on the existing article and the physical changes to the existing article, including the addition of new parts;
- 2) A comparison of the article's value before and after the work;
- 3) How favorably the performance of the remanufactured article compares with the performance of newly manufactured articles of its kind; and
- 4) Whether the work performed was contemplated as a normal part of the life cycle of the existing article.

Id. at 802-03. Therefore, like the taxpayer in *Rotation Products*, here, Taxpayer must satisfy all of the above to be considered a remanufacturer of cylinders.

In the Letter of Findings # 08-0577, the Department concluded Taxpayer did not meet its burden of proof. Specifically, Taxpayer did not satisfy the first prong and the fourth prong of the four-part test established by *Rotation Products*. At the rehearing, Taxpayer argued that it met these two prongs.

At the rehearing, Taxpayer explained that it was not claiming to remanufacture used cylinders per se, but that it remanufactures only the used cylinders which have passed the testing and recertifying process. Taxpayer specifically stated that irrespective of the actual testing of the cylinders, all steps preceding and following testing qualify as remanufacturing. At the rehearing, Taxpayer stated that a cylinder has four parts: (1) a tank which contains gas, (2) a neck ring which protects the tank's neck and identifies the cylinder's owner, (3) a valve which keeps gas inside the tank, and possibly (4) a dip-tube which attaches to the valve for certain cylinders in which the gases will need to be stirred or mixed. Taxpayer's documentation illustrates its multi-step process of testing and recertifying used gas cylinders in detail, summarized as follows:

- (1) Visual inspection – Upon arrival the cylinders are inspected visually. The cylinders that fail the visual inspection are discarded.
- (2) Preparation for testing – The remaining cylinders proceed to either Hydrostatic or Ultrasonic testing depending on the type of cylinder and/or the type of gas contained in the cylinder.
 - a. For those cylinders that are to undergo Hydrostatic testing, the valves are detached and the neck rings are removed from the tank. If the neck rings are in good condition, they are refurbished and reattached with sealant to the tanks. If the neck rings are damaged, they are replaced with new neck rings that are sealed onto the tank.
 - b. For those cylinders that are to undergo Ultrasonic testing, neither the valves nor the neck rings are removed prior to testing.
- (3) Testing – the cylinders undergo either Hydrostatic or Ultrasonic testing which involves placing the cylinders into large water vessels that are pressurized by a computer-operated machine. The cylinders that

fail Hydrostatic or Ultrasonic testing are discarded.

(4) Post-testing reassembly –

a. Valves – The valves that were removed from cylinders prior to Hydrostatic testing are refurbished and reattached to the cylinders if the valves are in good condition. If the valves are damaged, they are replaced. For the remaining cylinders, only the valves that are damaged are removed and replaced with new valves.

b. Dip-Tubes – For those cylinders that require dip-tubes, the tubes are inserted with the valve.

(5) Sandblasting/Painting surface – Old paint is sandblasted off of the cylinders and a new coat of paint is applied.

(6) Mark of recertification – The U.S. Department of Transportation's marks of recertification are stamped onto the cylinders.

(7) Cylinders returned to customers – The cylinders are loaded and shipped back to Taxpayer's customers, who are the owners of the cylinders. Taxpayer does not add any gases to the cylinders.

Apart from the fact that Taxpayer's argument appears contradictory, Taxpayer has not explained how this process supports their contention stated above that it remanufactures only the used cylinders which have passed the testing and recertifying process.

Occasionally, Taxpayer's customers wish to use the same cylinders for a different gas. When that is the case, during the recertification process, Taxpayer may change the valves or other components of the valve to comport with changed pressure requirements when a different gas is later used. Those cylinders then undergo the same process of testing pursuant to federal regulatory requirements.

The Department concluded that although Taxpayer's process of testing and recertifying used gas cylinders is complex, it does not substantially change the existing cylinders. Taxpayer, however, claimed that its process of testing and recertifying used gas cylinders is complex and, therefore, its process satisfies the first prong of Rotation Products.

Pursuant to Rotation Products, first, Taxpayer must show "substantiality and complexity of the work done on the existing article and the physical changes to the existing article, including the addition of new parts." Taxpayer argued that, aside from the testing step, the rest of the process satisfies the first prong of Rotation Products because the process is similar to the remanufacturing process described by the court in Rotation Products. However, the Department respectfully disagrees because, without the requisite testing, Taxpayer is not required to disassemble components of the cylinders and reassemble them or to replace them with new components after testing; i.e. testing drives the process and the activities flow from there.

Taxpayer argued that its process, involving measuring, shaping, cutting, and resizing the neck rings and dip-tubes, is similar to the remanufacturing process in Rotation Products. In Rotation Products, the taxpayer's remanufacturing process also involved measuring, shaping, grinding, cutting, or resizing the roller bearings. Thus, Taxpayer urged the Department to find that Taxpayer is a remanufacturer pursuant to Rotation Products because those steps, like the taxpayer's process in Rotation Products, involve intensive labor, tools, and machinery in order to ensure the components of the cylinders fit together snugly to contain gases within the cylinders.

However, in Rotation Products, the roller bearings were physically unusable and then repaired in a complex process that the court in Rotation Products found rose to the level of making new products. Here, Taxpayer does not repair the physically unusable cylinders or components. Taxpayer scraps the physically unusable cylinders and/or components.

The Rotation Products court explained:

In general, repair activity is not within the ambit of the industrial exemptions. This is so because ordinary repair creates no new products and is properly characterized as a service. Ordinary repair activity merely perpetuates existing products and although ordinary repair activity may impact the number of scarce economic goods by increasing their longevity, it cannot be said that ordinary repair produces scarce economic goods. Consequently, the industrial exemptions are properly denied in those cases.

However, as the legislature has recognized, at some point, the repair activity is so extensive in nature and so transforms the object such that it cannot be characterized as a mere service. Rather, the repair activity produces a new product and therefore constitutes exempt activity.

Rotation Products, 690 N.E.2d at 801. (Internal citations omitted.)

Unlike the taxpayer in Rotation Products that manufactures new roller bearings and also repairs the used ones, here, Taxpayer does not manufacture new cylinders or parts of cylinders, nor does Taxpayer repair the used cylinders or the parts. Taxpayer scraps the damaged or failed cylinders, it does not repair them. Also, Taxpayer merely refurbishes or replaces parts of the cylinders which pass the visual inspection and testing, and it likewise does not repair them. Moreover, unlike the owners of the roller bearings who sent the physically unusable roller bearings to the taxpayer in Rotation Products due to wear and tear, here, the owners of the cylinders most often send their cylinders to Taxpayer's facility when their cylinders need to be recertified because of federal statutory requirements. Taxpayer's documentation showed that a cylinder can be used for several decades before it fails the testing and recertifying process.

To further illustrate its point, Taxpayer used the example of automobiles to support its protest. Taxpayer

argued that a valve is to a cylinder as an engine is to a car; the cylinder is useless without a valve in the same way a car is useless without an engine. Thus, replacing the valve, like replacing the engine in a car, is remanufacturing because the replacement valve creates a new usable cylinder.

Taxpayer is mistaken. Replacing an engine in a car does not necessarily rise to the level of remanufacturing a new car. A car requires regular maintenance, including replacing brakes or other necessary parts of the car, so the car can run safely for years. The maintenance of the car is complex and often requires involvement of intensive labor, tools, and machinery, but those steps do not substantially change the existing article—the car. By the same token, replacing a valve of a used cylinder does not automatically rise to the level of remanufacturing a new cylinder. Applying Taxpayer's automobile analogy, the cylinders are designed to allow for these periodic changes.

Furthermore, the valve may be vital to the cylinder in order to contain the gases, but the tank is the most crucial component to the cylinder. Whether a cylinder can be recertified pursuant to the federal regulations depends on the physical condition of the tank. Specifically, when the tank is found to be damaged during the visual inspection or if the tank fails during testing, Taxpayer informs owner of the cylinder's failure. Taxpayer then sells those cylinders as scrap metal. Taxpayer does not repair these failed cylinders and transform them into physically usable cylinders. Only when the tanks pass the visual inspection and the testing, does Taxpayer replace or refurbish parts (except neck rings) of the cylinders. In short, Taxpayer's process, while involving multiple steps, is more like the ordinary repair that goes into the maintenance of an automobile than the extraordinary process of rendering unusable products into usable products in Rotation Products.

The Department also concluded that Taxpayer does not satisfy the fourth prong of Rotation Products. The fourth prong of Rotation Products looks at whether the work performed was contemplated as a normal part of the life cycle of the existing article. The court in Rotation Products examined the functionality of the roller bearings and noted that as the roller bearings perform, the inner and outer rings inside the roller bearings undergo friction. As a result, the roller bearings, at some point, become physically unusable and cease to function because of wear and tear. The court in Rotation Products found that there is no expectation attached to the purchases of roller bearings that the roller bearings could be reused again and again.

Here, Taxpayer claimed that the used cylinders it refurbishes are legally unusable upon their arrival because their certification has expired. Taxpayer argued that the life of a cylinder is five or ten years, i.e., the duration of certification or recertification. Without recertification, a cylinder is "unusable." Taxpayer argued that its process transforms those legally unusable cylinders to be legally usable again. Therefore, it satisfies the fourth prong of the Rotation Products.

However, remanufacturing is a process of producing physically usable goods, not a process to legalize physically usable goods. The federal mandates dictate the duration of a cylinder's certification depending on the intended use of cylinders. The cylinders which Taxpayer receives are for the most part still physically usable, but because of federal statutory requirements, the cylinders need to be tested and recertified to ensure the integrity of the cylinders. The owner of a cylinder could reasonably expect that the existing cylinder it has purchased could be reused again and again, i.e. physically usable, as long as the cylinder is recertified periodically under the federal regulations. Taxpayer's documentation shows that some of the cylinders which passed the testing and were recertified were manufactured in the 1940s. When cylinders are damaged or fail the testing, rendering the cylinders physically unusable, the cylinders are scrapped. Moreover, even though a cylinder's certification has expired, the federal regulations permit the owner of the cylinder to delay the recertification process when the cylinder still contains gas. Taxpayer does not test and recertify that cylinder until the gas has been used up. Therefore, unlike the physically unusable roller bearings, cylinders remain physically usable and function even after their certification has expired. Thus, the work which Taxpayer performs is contemplated as a normal part of the life cycle of the existing cylinders.

In conclusion, Taxpayer did not meet its burden of proof that it has satisfied the first and the fourth prongs of Rotation Products.

FINDING

Taxpayer's protest is respectfully denied.

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