DEPARTMENT OF STATE REVENUE

04-20100210.LOF

Letter of Findings Number: 04-20100210
Sales and Use Tax
For Tax Years 2006, 2007, 2008

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ISSUES

I. Sales and Use Tax–Imposition.

Authority: IC § 6-2.5-3-2; IC § 6-2.5-5-3; IC § 6-2.5-5-4; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; 45 IAC 2.2-5-8; 45 IAC 2.2-5-10; 45 IAC 15-3-2; Indiana Dep't of Revenue v. Interstate Warehousing, Inc., 783 N.E.2d 248 (Ind. 2003); North Cent. Indus., Inc., Company v. Indiana Dep't of Revenue, 790 N.E.2d 198 (Ind. Tax Ct. 2003); Rotation Prods. Corp. v. Dep't of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991).

Taxpayer protests the imposition of use tax on some items claiming that it is eligible for the manufacturing exemption.

STATEMENT OF FACTS

Taxpayer is an Indiana company in the scrap metal disposal and processing business. After an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed use tax and interest for the 2006, 2007, and 2008 tax years. The Department found that Taxpayer had made a variety of purchases upon which Taxpayer neither paid sales tax at the time of purchase nor remitted use tax to the Department. Taxpayer protested the assessment of tax. A hearing was held and this Letter of Findings ensues. Further facts will be supplied as required.

I. Sales and Use Tax–Imposition.

DISCUSSION

Taxpayer's protest is based on the claim that its recycling activities constitute "manufacturing" therefore qualifying it for the double-direct manufacturing exemptions from sales and use tax.

Taxpayer is reminded that all tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b), (c); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Furthermore, the taxpayer claiming exemption has the burden of showing the terms of the exemption statute are met. General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991) aff'd 599 N.E.2d 588 (Ind. 1992) (Internal citations omitted). Additionally "[e]xemption statutes are strictly construed because an exemption releases property from the obligation of bearing its fair share of the cost of government." Id.

Indiana imposes "an excise tax, known as the use tax," on tangible personal property that is acquired in retail transactions and is stored, used, or consumed in Indiana. IC § 6-2.5-3-2(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. 45 IAC 2.2-5-8(a). The exemption only 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 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. 45 IAC 2.2-5-8(c). 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)(1).

IC § 6-2.5-5-4 extends the exemption to tools used to build exempt machinery and equipment.

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for his direct use in the direct production of the machinery, tools, or equipment described in section 2 or 3 of this chapter.

To summarize, machinery, tools, and equipment purchased for direct use in the production of a manufactured good are subject to use tax unless the property used has an immediate effect on the good produced and is essential to the integrated process used to produce the marketable good.

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.

Taxpayer purchases non-ferrous metals from businesses and individuals. At its non-ferrous metals warehouse Taxpayer has a machine that sorts aluminum cans from "bad" cans. The cans are then crushed and

bailed together with straps. The bailed cans are then resold. Other non-ferrous metals (copper) are hand-sorted. When sorted, the metal has to be stripped and cut to specification. Taxpayer uses an alligator shear cutter to cut the copper tubing down in length to be recycled. The shear cutter is also used to get the solder off of the copper to meet mill requirements.

At its scrap yard, Taxpayer receives both ferrous and non-ferrous metals. The metal comes into the facility in trucks. The loads are weighed and directed to the different areas of the scrap yard depending on what type of metal is in the load. The metal is unloaded and cranes are used to separate the material in the scrap piles. Nonferrous material is cut or crushed and bailed in the scrap yard. Ferrous metals are cut and bailed in the warehouse. Cranes are used to move the scrap from one location to the next.

The Department's audit points out that Taxpayer does not add any material to the metals it processes at either the warehouse or the scrap yard. The Department's audit reiterates that Taxpayer sorts, cleans and repackages the scrap metal for resale.

Taxpayer maintains that its process results in a new, more marketable product and that Taxpayer is therefore entitled to the exemption found in IC § 6-2.5-5-3(b). Taxpayer also points out that it had contacted the Department previously and was told it would qualify for the manufacturing exemption. 45 IAC 15-3-2(e) clearly states oral opinions will not be binding on the Department. Even when a taxpayer orally receives technical assistance from the Department, the advice is advisory only and is not binding. In recognition of Taxpayer's reliance, however, the Department's audit did not assess the ten-percent negligence penalty.

As to the substance of Taxpayer's protest, the Department's regulations emphasize that the tangible personal property that are the "raw materials" of a manufacturing/ processing/refining process must be substantially changed in their "form, composition, or character" such that the resulting tangible personal property is a different product having a distinctive "name, character, and use." The resulting product must be substantially different from the component materials used.

45 IAC 2.2-5-8(k) states:

> "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).

45 IAC 2.2-5-10(k) states:

> Definitions. Processing or refining is defined as the performance by 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. Operations such as distilling, brewing, pasteurizing, electroplating, galvanizing, anodizing, impregnating, cooking, heat treating, and slaughtering of animals for meal or meal products are illustrative of the types of operations which constitute processing or refining, although any operation which has such a result may be processing or refining. A processed or refined end product, however, must be substantially different from the component materials used.

The Indiana Supreme Court has provided guidance on this issue in Indiana Dep't of Revenue v. Interstate Warehousing, Inc., 783 N.E.2d 248 (Ind. 2003). The Indiana Supreme Court explained that the Indiana Tax Court had addressed the exemption in several prior cases. The court stated:

> The common thread in all of these cases is that where the taxpayer did not transform property into a distinct marketable product for customer consumption, the Tax Court held that the taxpayer was not engaged in the "production of other tangible personal property." We agree with the Tax Court's analysis in those cases. Id. at 251.

As provided above by the court in Interstate Warehousing, any taxpayer claiming the exemption provided by IC § 6-2.5-5-5.1 must transform property into a "distinct marketable product for customer consumption" in order to qualify for the exemption. This requirement also applies to the exemption provided by IC § 6-2.5-5-3. The Indiana Tax Court has provided guidance when determining what constitutes manufacturing. In Rotation Prods. Corp. v. Indiana Dep't of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998), that taxpayer claimed that it was remanufacturing ball bearings and was therefore eligible for the manufacturing exemption. The court explained:

> Usually, a substantial amount of work will have to be performed to transform materials with only scrap value into serviceable and marketable products. In most cases, the substantial amount of work required will "result in an 'end product' that is 'substantially different from the component materials used.'" Id., at 802.

In Rotation Products, the discussion focused on whether or not remanufacturing constituted manufacturing as used in the exemption statutes. While this protest concerns a recycling operation instead of a remanufacturing operation, a review of the court's reasoning is helpful. The court provided a four-part test to answer the question of how to determine if a taxpayer is in the business of manufacturing, as follows:

> The case law reveals three factors germane to this fact-sensitive inquiry. The first is an adaptation of the requirement of a substantially different end product: 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. The other two factors derive from the observations of the courts dealing with this issue: a comparison of the article's value before and after the work, MACROBUTTON HtmlResAnchor and how favorably the performance of the remanufactured article compares with the performance of newly manufactured articles of its kind. Additionally, this Court concludes that another factor is applicable to this inquiry: whether the work performed was contemplated as a normal part of the life cycle of the existing article. This additional factor will prevent work that merely perpetuates existing products from qualifying for an industrial exemption.
> Id., at 802-3.

The first factor weighs the substantiality and complexity of the work done on the existing article, including the addition of new parts. In the instant case, Taxpayer does not add new parts to the scrap; in most cases, Taxpayer separates and "repackages" the scrap. Taxpayer, at most, separates items into groupings defined by their material composition, cleans items, and/or cuts or crushes items before bundling them. The recyclable materials have no functionality as products, but only have value as the metals or other recyclable content. In other words, Taxpayer starts with scrap aluminum, copper, brass, steel, etc., and then ends with scrap aluminum, copper, brass, steel, etc. Taxpayer does not create a new product–i.e., such as a new alloyed metal. Thus, while Taxpayer's customers may prefer to purchase only in packaged bundles and pay Taxpayer for the convenience of these services, Taxpayer has merely repackaged the existing recyclable material. The Tax Court addressed the issue of repacking in North Cent. Indus., Inc., Co. v. Indiana Dep't of State Revenue, 790 N.E.2d 198, 201 (Ind. Tax Ct. 2003) and explained that "merely packag[ing] existing [property]... is not the sort of substantial change or transformation that places property 'in a form, composition, or character different from that in which [they were] acquired.' 45 IAC 2.2-5-8(k)." Since there is no new article produced, Taxpayer's activities do not pass the first factor of the Rotation Products test and review of the other factors is unnecessary.

In the instant case, Taxpayer did not substantially change or transform the scrap metal. Taxpayer simply repackaged the scrap metal in bales after its process is completed. As provided by Rotation Products and North Central Industries, a taxpayer's activities must result in something new in order to qualify for the exemption found in IC § 6-2.5-5-3(b). Taxpayer's activities result in repackaging of the same scrap metal, from unbaled to baled. There is nothing new produced. Therefore, the Department is not able to agree that Taxpayer met its burden pursuant to IC § 6-8.1-5-1(c).

As Letter of Findings 04-20090014.SLOF (December 17, 2010) states:

> The Department does not disparage the rationale of Taxpayer's protest or seek to underestimate the value of Taxpayer's operations nor does it treat as insignificant the costs related to those operations. However, in asking the question of whether the Taxpayer's recycling process results in a "substantially different" product, the Department concludes that it does not; the various metals and other materials are essentially the same metals and materials at the beginning and at the end of the process. In answering the question of whether Taxpayer's recycling activity can be "strictly construed" as entitled to an exemption under IC § 6-2.5-5-3(b) the Department must likewise conclude that it does not. Taxpayer's protest de facto seeks by administrative review to broaden the statutory sales and use tax exemptions to include recycling equipment; the expansion of this exemption is a task more properly addressed by the General Assembly.

As Mechanics Laundry & Supply, Inc. v. Indiana Dep't of State Revenue., 650 N.E.2d 1223 (Ind. Tax Ct. 1995) states unequivocally in footnote 11 (reiterated a few years later in Rotation Products, 690 N.E.2d at 803 n. 15):

> If the equipment exemption is to be broadened to include recycling, as perhaps it should be, such action must come from the Indiana General Assembly.
> Mechanics Laundry at 1230.

FINDING

Taxpayer's protest is respectfully denied.

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