

Letter of Findings: 04-20100485
Sales and Use Tax
For the Years 2007, 2008, and 2009

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Sales and Use Tax – Exemptions.

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](#); [45 IAC 2.2-5-12](#); Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dept. of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. App. 1974); Rotation Products Corp. v. Department of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998); North Cent. Industries, Inc. v. Indiana Dept. of State Revenue, 790 N.E.2d 198 (Ind. Tax Ct. 2003).

Taxpayer protests the assessment of tax on its purchase of tangible personal property.

STATEMENT OF FACTS

Taxpayer, an Indiana company, is a manufacturer of air filter frames as well as retail display and packaging materials. The Indiana Department of Revenue ("Department") conducted a sales/use tax audit for tax years 2007, 2008, and 2009. Pursuant to the audit, the Department determined that Taxpayer purchased tangible personal property, including, but not limited to, computer software, plant and office supplies, repair parts, and strapping machines, without paying sales tax at the time of the purchase or self-assessing and remitting to the Department the use tax due. Thus, the Department's audit assessed Taxpayer additional use tax and interest.

Taxpayer only protested the assessment on its purchase of a baler system. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Exemptions.

DISCUSSION

The Department's audit assessed Taxpayer use tax on its purchase of a baler system. Taxpayer, to the contrary, claimed that it was entitled to a statutory exemption on its purchase of the baler system.

As a threshold issue, 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 Dept. 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. Generally, 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. There are also additional exemptions from sales tax and use tax. A statute which provides a tax exemption, however, is strictly construed against the taxpayer. Indiana Dept. of State Revenue v. RCA Corp., 310 N.E.2d 96, 97 (Ind. App. 1974).

IC § 6-2.5-5-3(b), in relevant part, states:

[T]ransactions 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. [45 IAC 2.2-5-8\(a\)](#). 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.

The exemption for direct use in production is explained at [45 IAC 2.2-5-11](#) and the exemption for direct consumption in production is further explained at [45 IAC 2.2-5-12](#).

Additionally, [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.

[45 IAC 2.2-5-8](#)(f) provides:

(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.

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

"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. **(Emphasis added).**

The Indiana Tax Court has provided explanation of the manufacturing exemption in *Rotation Products Corp. v. Department of State Revenue*, 690 N.E.2d 795 (Ind.Tax,1998), where the taxpayer was engaged in remanufacturing ball bearings. In that case the court explained:

Cave Stone's approach to the industrial exemptions has been applied to cases where the question was whether a product was created. For example, in *Harlan Sprague Dawley*, this Court drew from the teaching of Cave Stone in concluding that specially bred laboratory rats were products: "In the context of the industrial exemptions, production is viewed expansively as all activity directed to increasing the number of scarce economic goods." *Harlan Sprague Dawley*, 605 N.E.2d at 1228 (quoting *Cave Stone*, 457 N.E.2d at 524) (internal quotation marks omitted). The laboratory rats were scarce economic goods. Laboratories used them for specialized research, and the rats were much more suitable for that research than their naturally occurring counterparts. Consequently, this Court found that they were products and held that the taxpayer was entitled to the industrial exemptions.

Id. at 799.

The court further explained:

Subsequent case law has reemphasized *Harlan Sprague Dawley's* focus on whether a product was created. In *Mechanics Laundry & Supply, Inc. v. Dep't of State Revenue*, 650 N.E.2d 1223 (Ind. Tax Ct. 1994), this Court evaluated whether the laundering of textiles constituted processing in the context of the industrial exemptions. In concluding that it did not, this Court found that the laundering of soiled textiles merely "perpetuated textiles that were produced by others." Id. at 1230 (citing *Undercofler v. Macon Linen Serv., Inc.*, 114 Ga. App. 231, 241, 150 S.E.2d 703, 709 (1966)). See also *Indiana Waste Sys. v. Dep't of State Revenue*, 633 N.E.2d 359 (Ind. Tax Ct. 1994) (taxpayer not entitled to exemption where taxpayer compressed garbage but did not produce other tangible personal property). Because the taxpayer in *Mechanics Laundry* produced no new tangible personal property, it was not entitled to the industrial exemption.

In *Mid-America Energy Resources*, this Court held that a taxpayer who chilled water for use in customers' air conditioning systems was entitled to an exemption for equipment used and materials consumed in the production of the chilled water. This Court focused its inquiry on whether the taxpayer's operation created a marketable good. "When goods are not produced, and a service is provided, the [industrial] exemptions are properly denied." (internal citation omitted).

Id. at 799-80.

The court further provided:

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, 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. See *Mechanics Laundry*, 650 N.E.2d at 1230.

Id. at 802-3.

Finally, the court explained:

Finally, an analysis of the fourth factor favors RPC as well. Even if cleaning and polishing are a normal part of a roller bearing's life cycle (i.e., routine maintenance), it cannot be said that grinding away the load bearing surfaces of the roller bearing and replacing the roller cages and rolling elements are a normal part of that life cycle. (When RPC's customers bring the non-functional bearings to RPC, they do not know whether the bearings can be salvaged at all.) This is to be contrasted with the shirts at issue in *Mechanics Laundry*. Shirts are bought with the expectation that they will be washed again and again. No such expectation attaches to the purchase of roller bearings.

Id. at 803-4.

The court concluded that the taxpayer in that case was entitled to the exemption since its activities resulted in an essentially new product which went beyond the expected life cycle of the ball bearings as originally produced.

In this instance, Taxpayer maintained that:

The stamping of the filter frames in a large amount of scrap per unit of raw material. As such, an integrated system must be utilized to pull this scrap from the system on a continuous basis as to avoid a shut-down of the entire process.

The baler is part of an integrated and uninterrupted system that removes the scrap paper from the process on an ongoing basis.... The baler is the final piece of equipment on five different production lines, with each line utilizing a die cutter to punch out the scrap which is immediately and continuously vacuumed into the baler system via blow pipes. If this function were not available, production would not be possible for any of the respective lines due to excessive clogging of the actual die cutters. As it is removed, the baling machine compresses and bales the loose scrap material into blocks of uniform density.

Further, the bales of scrap material are ultimately sold to the original raw material provider. As such, the baler can be considered a piece of equipment that changes the form and packages a product that is ultimately sold.

Taxpayer's documentation demonstrated that it bales its scrap cardboard paper after its manufacturing production is concluded and the finished products—filter frames or retail display and packaging materials—were produced. Unlike the activities in *Rotation Products*, Taxpayer's use of the baler did not result in a product which goes beyond the expected life cycle of the scrap cardboard paper. Thus, the baled scrap cardboard paper was the by-product after Taxpayer completed its manufacturing production and the use of the baler was post-production.

Taxpayer's documentation also demonstrated that its activities repackage the pre-existing product. This is a similar situation to *North Cent. Industries, Inc. v. Indiana Dept. of State Revenue*, 790 N.E.2d 198 (Ind. Tax Ct. 2003), where the taxpayer bought fireworks in bulk and sold packages containing a variety of fireworks. In that case, the court explained:

Although "there are innumerable ways to produce other tangible personal property, [Indiana Code Section 6-2.5-5-3] cannot be expected to give a precise answer to each factual situation that arises." *Rotation Prod.*, 690 N.E.2d at 798. Nevertheless, the Department's rules make clear that production must entail a "substantial" change or transformation that "places tangible personal property in a form, composition, or character different from that in which it was acquired." IND. ADMIN. CODE tit. 45, r. 2.2-5-8(k) (2001). Moreover, production must increase the number of "scarce economic goods," i.e., it must create a new, marketable product. *Harlan Sprague Dawley, Inc. v. Indiana Dep't of State Revenue*, 605 N.E.2d 1222, 1226 (Ind. Tax Ct. 1992) (quoting *Borden Co. v. Borella*, 325 U.S. 679, 89 L. Ed. 1865, 65 S. Ct. 1223 (1945)). Id. at 200.

Also, the court explained:

North Central does not create a new, marketable product; it merely packages existing fireworks into boxes, then labels and shrink-wraps them. This is not the sort of substantial change or transformation that places the fireworks "in a form, composition, or character different from that in which [they were] acquired." [45 IAC 2.2-5-8\(k\)](#). See also *Indianapolis Fruit*, 691 N.E.2d at 1386; *Mechanics Laundry & Supplies, Inc. v. Indiana Dep't of State Revenue*, 650 N.E.2d 1223, 1229 (Ind. Tax Ct. 1995) (holding that producing a good is not merely perpetuating already existing goods); *Harlan Sprague Dawley*, 605 N.E.2d at 1229; *Faris Mailing*, 512 N.E.2d at 483. Nor does North Central's process increase the number of "scarce economic goods," see *Harlan Sprague Dawley*, 605 N.E.2d at 1225, because the same number of fireworks are sold regardless of the way they are packaged. Consequently, North Central's activities do not constitute the direct production or manufacture of other tangible personal property.

Id. at 201-2.

In the instant case, Taxpayer did not substantially change or transform the scrap cardboard paper. Taxpayer

simply repackaged the scrap cardboard paper in bales after its manufacturing process is completed and its finished products were produced. As provided by Rotation Products and North Cent. 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 cardboard paper, 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).

Accordingly, the "scrap cardboard paper" is a by-product of Taxpayer's production process. Taxpayer's use of the baler system is not used in connection with the direct production process of its filter frames. Instead, Taxpayer's use of the baler system is in connection with the disposition of the "scrap cardboard paper"—which is the by-product of Taxpayer's production process. The use of the baler system is, therefore, a post-production, and its use of the baler system is, at best, considered a practical necessity because it is easier to transport the baled scrap cardboard paper than scattered cardboard paper.

In short, Taxpayer is not entitled to receive the exemption for its purchase of the baler system. Since Taxpayer did not pay sales tax at the time of the purchase, use tax is properly imposed.

FINDING

Taxpayer's protest is respectfully denied.

Posted: 03/23/2011 by Legislative Services Agency
An [html](#) version of this document.