

Letter of Findings: 04-20100346
Sales and Use Tax
For the Years 2007, 2008, 2009

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ISSUES

I. Sales and Use Tax – Manufacturing Exemptions.

Authority: IC § 6-2.5-3-2; IC § 6-2.5-5-3; IC § 6-2.5-5-4; IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't of Revenue v. Cave Stone Inc., 457 N.E.2d 520 (Ind. 1983); Indiana Dep't of Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); General Motors Corp. v. Indiana Dep't of Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Dep't of Revenue v. United States Steel Corp., 425 N.E.2d 659 (Ind. Ct. App. 1981).

Taxpayer protests the assessment of use tax on several items it claims qualify for the manufacturing exemptions.

STATEMENT OF FACTS

Taxpayer is an Indiana company in the business of designing and manufacturing die cast molds and special tooling for use by the automotive industry in producing automotive transmissions and engine blocks in Indiana and surrounding states. Taxpayer was placed in receivership by the local Circuit Court.

The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer for the years 2007, 2008, and 2009. Due to the large volume of purchase invoices, Taxpayer and the Department's auditor agreed to use a sampling methodology where invoices from October 1, 2007, through September 30, 2008, were reviewed to establish a percentage error rate. The percentage error rate was then applied to the remaining periods of the audit. Pursuant to the audit, Taxpayer was assessed additional use tax and interest. Taxpayer's receiver protested all of the items on which use tax was assessed (all references in the Letter of Findings will be to Taxpayer rather than to its receiver). A hearing was held on Taxpayer's protest. After the hearing, Taxpayer reduced the items protested to three. This Letter of Findings addresses the remaining issues. Additional facts will be provided as required.

I. Sales and Use Tax – Manufacturing Exemptions.

DISCUSSION

In a letter dated September 20, 2010, Taxpayer delineates the remaining items that it is protesting. These items are (1) Zep Dry Graphite, (2) Teleweld testing equipment, and (3) Grainger aluminized coating apparel. Taxpayer maintains that as a manufacturer the purchases of certain items it used in its manufacturing process were exempt under the "manufacturing exemption" in IC § 6-2.5-5-3(b).

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).

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 when sales tax has not been otherwise paid. 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); Indiana Dep't of Revenue v. Cave Stone Inc., 457 N.E.2d 520 (Ind. 1983). 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).

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.

In applying any tax exemption the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dep't of Revenue v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

In order to determine whether an item is directly used in Taxpayer's direct production process, it is necessary to identify Taxpayer's production process in order to determine what falls within it (and is therefore exempt), or

whether a particular process falls in pre-production or post-production (and is therefore not exempt under the manufacturing exemptions).

[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.

Neither the Department's audit nor Taxpayer's protest and/or post-hearing submissions describe Taxpayer's production process sufficiently.

A. "Zep Dry Graphite."

Taxpayer states that the Zep Dry Graphite is a highly adhesive lubricant that is able to withstand temperatures of 1000 degrees Fahrenheit. Taxpayer explains that it uses the dry graphite in its direct production process to assemble and attach various parts of property that Taxpayer produces.

Taxpayer has provided sufficient explanation to show that this item is used on parts that are "work in process"; i.e., the production process is still not complete and this item is directly used during the direct production process. [45 IAC 2.2-5-8](#).

Taxpayer's protest is sustained on this item.

B. "Teleweld testing equipment."

Taxpayer explains that its customers require that the metal composition in its products have a specific degree of hardness. Taxpayer further explains that the Teleweld testing equipment is used by Taxpayer to determine whether its products meet the specific degrees of metal hardness required by customers. Taxpayer argues that it would not be able to determine whether it had produced the customer's desired product without using the Teleweld equipment.

Machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt. [45 IAC 2.2-5-8](#)(i).

Taxpayer has provided sufficient explanation to demonstrate that this item qualifies for the manufacturing exemption.

Taxpayer's protest of this item is sustained.

C. "Grainger aluminized coating apparel."

Taxpayer explains that its workers must wear the aluminized coating to clean and maintain furnaces that Taxpayer uses in its production process. Taxpayer argues that the aluminized coating is essential for workers to determine whether the furnaces are operational. Taxpayer concedes that while protective clothing may often be taxable, nonetheless it is exempt when it represents a necessary condition for carrying out the production process. Taxpayer cites to *Dep't of Revenue v. United States Steel Corp.*, 425 N.E.2d 659 (Ind. Ct. App. 1981) for the proposition that safety equipment is exempt if such equipment is required for workers to carry out production operations.

Machinery, tools and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax. [45 IAC 2.2-5-8](#)(h)(1).

Taxpayer states that the protective coating is used by Taxpayer's employees during their maintenance of furnaces Taxpayer uses in its production process. Presumably this maintenance work takes place outside an active production process. The protective coating used by the employees falls under activities contemplated by [45 IAC 2.2-5-8](#)(h)(1) and are therefore taxable.

The fact that a particular item 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 item has an immediate effect upon the article being produced. [45 IAC 2.2-5-8](#)(g).

Taxpayer's protest on this item is respectfully denied.

FINDINGS

Taxpayer's protest of the assessment of use tax on the Zep Dry Graphite and the Teleweld testing equipment is sustained. Taxpayer's protest of the assessment of use tax on the Grainger aluminized coating is denied.

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