

Supplemental Letter of Findings: 04-20100644
Gross Retail Tax
For the Years 2005, 2006, and 2007

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ISSUES

I. Direct Production – Gross Retail Tax.

Authority: IC § 6-8.1-5-1(c); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282 (Ind. Tax Ct. 1999); Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-8\(c\)](#); [45 IAC 2.2-5-8\(c\)\(2\)\(A\)](#); [45 IAC 2.2-5-8\(f\)\(1\)](#); [45 IAC 2.2-5-10\(c\)](#); [45 IAC 2.2-5-10\(c\)\(2\)](#); [45 IAC 2.2-5-12](#).

Taxpayer argues that certain items of equipment and supplies are exempt from sales/use tax because the items are directly used in the direct production of Taxpayer's food products.

II. Lift Trucks – Gross Retail Tax.

Authority: General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); [45 IAC 2.2-5-8\(e\)\(1\)](#); Supplemental Letter of Findings 04-20020014 (June 12, 2003); Letter of Findings 04-20010242 (November 21, 2002).

Taxpayer asks the Department to reconsider its position that Taxpayer does not operate a continuous integrated production process from turkey raising facility, to feed mill, to an initial production facility in one location, to another production facility in another geographic location.

STATEMENT OF FACTS

Taxpayer operates a turkey processing plant in Indiana, a feed mill plant in Indiana, and various other facilities within the state. Taxpayer also operates facilities outside Indiana. The Department of Revenue ("Department") conducted an audit review of Taxpayer's sales and use tax compliance. The Department's audit began in 2007 and was concluded in 2010. The audit resulted in the assessment of additional sales/use tax.

Taxpayer protested substantially all of the audit's findings. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. Letter of Findings 04-20100644 (March 15, 2011) was written in which Taxpayer's protest was sustained in part and denied in part. Taxpayer disagreed with conclusions contained within the Letter of Findings and submitted a request for a rehearing. The rehearing was granted but was limited to twelve specific items or categories of equipment. A second administrative hearing was conducted during which Taxpayer's representatives again explained the basis for their objections. This Supplemental Letter of Findings results.

I. Direct Production – Gross Retail Tax.

DISCUSSION

Taxpayer argues that it purchased certain items of equipment and supplies which are exempt from sales/use tax.

The Department agreed to revisit issues but limited review to twelve specific items or categories of equipment on the ground that – for these particular items – Taxpayer had met a threshold standard of establishing that the items should have been categorized as exempt from sales/use tax and that the additional information supplied was sufficient to warrant revisiting the issue.

The items at issue included:

- Ice Conveyor
- Air Compressor
- Box Erecter
- Chemicals; Sodium Hypochlorite; Sodium Acid Sulfate
- Chlorine Rinse Cabinet
- Deboning Conveyor Roller
- Neck Chiller Conduit Clamps
- Neck Chiller
- Defeather Sheaves
- Thigh Deboning Conveyor
- Hydraulic Conveyor "Part"
- Shackles

During the course of the administrative hearing at which these items were discussed, it was determined that the "Chlorine Rinse Cabinet" was not in fact one of the items which Taxpayer believed was exempt from sales/use

tax. Therefore the taxability of this particular item will not be discussed here leaving eleven items – the two chemicals are counted as one item – for consideration in this Supplemental Letter of Findings.

For the most part, Taxpayer believes these items are exempt because they are directly used in the direct production of Taxpayer's food products.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "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."

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dept. of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

Exemption provisions are strictly construed against exemption from the tax. *Tri-States Double Cola Bottling Co. v. Dep't of State Revenue*, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); *Mynsberge v. Dep't of State Revenue*, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999).

A. Exempt Equipment.

The following items can reasonably be considered together in this section; those items include the "Deboning Conveyor Roller," "Neck Chiller Conduit Clamps," "Neck Chiller," "Defeather Sheaves," "Thigh Deboning Conveyor," and "Hydraulic Conveyor Part."

In the additional documentation supplied at the time Taxpayer requested the rehearing, Taxpayer classified these items as "miscellaneous" but failed to cite any specific authority supporting its contention that the items are exempt from sales use tax. However, based on the conversations conducted during the supplemental hearing, the Department will assume that the items fall under the following regulatory provision.

[45 IAC 2.2-5-8](#) in part states as follows:

(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. The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.

(b) The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property.

(c) The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. 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. (Emphasis added).

The Department is prepared to agree that Taxpayer has met its burden of demonstrating that the eight items listed above "have an immediate effect on the article being produced" and that the items are "directly used by [Taxpayer] in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property." Id. The "tangible personal property" being produced consists of Taxpayer's food products.

B. Shackles.

Taxpayer challenges the Department's determination that 25 percent of its shackles are not exempt. The shackles are used to hang turkeys as the animals proceed through the production process. The Department's audit determined that the shackles were partly used "within the production process" and partly used "outside the production process." Taxpayer cites to Departmental regulation [45 IAC 2.2-5-10\(c\)](#) as support for its contention that the shackles are used 100 percent of the time within its integrated production process. The regulation states:

Purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in processing or refining are exempt from tax; provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the tangible personal property being processed or refined. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which processes or refines tangible personal property.

The Department is reluctant to second-guess the audit's considered judgment as to precisely when and where Taxpayer's production process began and where it ended and to what extent the shackles operate within that process and to what extent the shackles operate outside that process. Taxpayer may well be correct but there is nothing definitive which establishes that the audit's conclusion – that the shackles are taxable in part – was wrong.

C. Ice Conveyor.

Taxpayer argues that its Ice Conveyor is exempt. Taxpayer argues that in the processing of its food products, it is "vital to cool the product and maintain it at proper temperature to produce a product that can be sold per both [Taxpayer] and USDA requirements."

In support of its argument, Taxpayer cites to Departmental regulation [45 IAC 2.2-5-10\(c\)\(2\)](#).

(2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment is built in a manner to service various pieces of exempt equipment, as an alternative to building the equipment into each of the pieces of exempt machinery, is not determinative.

(A) Pumps used to circulate cooling water through exempt condensers in the distillery.

(B) Chemicals used to treat the water used in the production of whiskey to ensure that the water is pure or to prevent scale buildup in the boilers and pipes.

(C) Equipment used to pulverize coal prior to being fed into the exempt boiler used to generate steam in the distillation process.

(D) A bottling and packaging process, which includes equipment such as case and bottle conveyors used during the filling operations, equipment to fill the bottles with product and to place labels on the bottles, and case filling equipment and case palletizers. The exempt production process begins after the bottles are introduced onto the bottle conveyors for the filling step of production and ends with the final packaging of the product onto the case palletizers.

Based on the discussion with Taxpayer's representatives during the second administrative hearing, Taxpayer apparently operates an ice making machine. Crushed ice is transported by the conveyor in question to Taxpayer's production line in which turkeys are being processed into Taxpayer's various food products. The crushed ice is added to tanks containing water in which the turkeys are immersed. The crushed ice is also added to trays which contain or transport turkey parts. Taxpayer believes that the ice conveyor is exempt pursuant to [45 IAC 2.2-5-8\(c\)](#) which states:

"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.

The issue is whether the ice conveyor falls within the production process whereby Taxpayer produces its food products. The ice conveyor is not transporting Taxpayer's meat products within the production process; the conveyor moves a "raw material" – the ice used to preserve and protect the meat products – and consideration of the conveyor best falls under [45 IAC 2.2-5-8\(f\)\(1\)](#) which states that, "Tangible personal property used for moving raw materials prior to their entrance into the production process is taxable." (Emphasis added).

D. Air Compressor.

Taxpayer maintains that the "air compressor" is exempt. The original Letter of Findings noted that Taxpayer's own representative replied to the audit's question concerning this device as follows:

This is an air compressor used as a power source to operate all of the pneumatic processing equipment throughout the plant in accordance with [45 IAC 2.2-5-8\(c\)\(2\)\(A\)](#). Vacuum system is for the lun[g] and kidney vacuum extractor to remove the parts from the turkey as part of the process.

The audit found this explanation insufficient and sought further clarification. As a result, the on-site representative stated that the air compressor was used to "operate pneumatic production equipment."

The audit sought yet further clarification finding that the initial two responses appeared contradictory. In a third response, Taxpayer's on-site representative stated that the air compressor was principally used "50[percent] for pneumatic processing equipment and 50[percent] for lung & kidney extraction."

The original audit found that extraction equipment was not exempt a decision which was sustained in the Letter of Findings; As noted in the original Letter of Findings, "[T]he extraction equipment was used in an exempt manner 50 percent of the time and allowed a partial exemption for the extraction equipment."

Based on an analysis of the extent to which the compressor was used to operate exempt production equipment and the extent to which the compressor was used to operate the non-exempt extraction equipment, the audit determined that the compressor was 75 percent exempt and 25 percent non-exempt.

Taxpayer now provides yet one more explanation. Stating the "[a]ir compressor powers the pneumatic system" and not the extraction equipment.

[45 IAC 2.2-5-8\(c\)\(2\)\(A\)](#) which exempts, "Air compressors used as a power source for exempt tools and machinery in the production process." (Emphasis added). The audit has already determined that the compressor is used in an exempt manner 75 percent of the time. Even assuming that the compressor is not used to operate the extraction equipment, there is not sufficient information to establish to what extent the air compressor operates exempt equipment and to what extent the air compressor operates non-exempt equipment. The Department is unable to agree that Taxpayer has established the audit's original calculation is wrong pursuant to IC § 6-8.1-5-1(c).

E. Chemicals.

Taxpayer maintains that its purchases of Sodium Hypochlorite and Sodium Acid Sulfate are exempt because the chemicals are "directly consumed in direct production" of its food products pursuant to [45 IAC 2.2-5-12](#). Taxpayer has provided information explaining the manner in which these chemicals are used. Taxpayer states that these antimicrobial chemicals are added to chilled water in the "whole bird rinse cabinets" and on the "belt washers" in order to reduce the bacteria[l] load of carcasses.... The chemicals are pumped from a "4,000 gallon tank to the various rinse cabinets and belt washers throughout the plant." In the case of the two chemicals cited,

Taxpayer has met its burden of establishing that it is entitled to the exemption set out in [45 IAC 2.2-5-12](#).

F. Box Erecter.

Taxpayer argues that it is entitled to an exemption on the purchase of a box erector. The device apparently does what its name implies. As Taxpayer explains, the device "makes boxes." The Department is unable to agree that the box erector is exempt pursuant to [45 IAC 2.2-5-10\(c\)](#) because the box erector does not "have an immediate effect on the tangible personal property being processed or refined" the "tangible personal property" being produced by Taxpayer is – of course – the food products.

FINDING

Taxpayer's protest is sustained in part and denied in part.

II. Lift Trucks – Gross Retail Tax.

DISCUSSION

At the time the rehearing was granted, the Department agreed that certain issues would be revisited and certain other items would not be revisited during the supplemental administrative review. However, Taxpayer repeats its request that the Department revisit the "Forklifts and Refrigeration" on the ground that Taxpayer operates a "continuous production process" between its various in-state and out-of-state facilities; Taxpayer strenuously objects to the conclusion reached in the original Letter of Findings that it does not operate a continuous production process.

As explained in the "Statement of Facts" section of the Letter of Findings, Taxpayer operates a processing plant in Indiana, an Indiana feed mill, a related company which breeds turkeys, and at least one out-of-state facility which receives Taxpayer's food products and further processes those products into additional saleable food products. Taxpayer explains that it operates on "an extremely well coordinated schedule," that its products have a very short shelf life, and that all of its "departments are in communication and work together to assure that the birds are grown and brought to the plant...."

Taxpayer points to [45 IAC 2.2-5-8\(e\)\(1\)](#) which states that "[t]angible personal property used in or for the purpose of storing work-in-process or semi-finished goods is not subject to tax if the work-in-process or semi-finished goods are ultimately completely produced for resale and in fact resold."

In effect, Taxpayer asks that equipment and supplies which are used or consumed between Taxpayer's various in-state and out-of-state facilities be exempted because – in effect – Taxpayer operates one continuous operation food production facility which includes the farms on which the turkey are raised to the out-of-state facility which provides additional processing of Taxpayer's food products. As noted in the original Letter of Findings,

Taxpayer's argument is apparently predicated on the assumption that its various production facilities constitute a "continuous integrated production process" as described in *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991).

It is not necessary to reanalyze this case in detail because it was reviewed in the original Letter of Findings and has been considered by the Department in other Letters of Findings. See Supplemental Letter of Findings 04-20020014 (June 12, 2003); Letter of Findings 0420010242 (November 21, 2002).

Essentially, the *General Motors* court redefined the various far-flung automobile manufacturing facilities as one continuous, integrated, manufacturing process such that the automobile manufacturer's purchase of packing materials, used to facilitate the transfer of unfinished goods within that integrated production process, was essential and integral to the taxpayer's manufacturing process and, thereby, was entitled to the manufacturing exemption available under IC § 6-2.5-5-3. Among the evidence cited as relevant in determining that automobile manufacturer operated a continuous, integrated, manufacturing process, the court found that automobile manufacturer's personnel, located at its various plants, together collaborated to develop new products, together designed and engineered new parts and packing materials, together planned the production processes for new parts, and together mutually solved problems and ensured product quality. *General Motors*, 578 N.E.2d. at 403 n.3. In addition, the court held that the "continuity of production exist[ed] between [automobile manufacturer's] different plants [was] demonstrated by the standard practice of shifting certain production operations back and forth between component and assembly plants when necessary for more efficient operation." *Id.*

The *General Motors* establishes a threshold under which geographically distinct production facilities operate as one seamless, integrated manufacturing operation. The Department does not disagree that Taxpayer's food production operation is coordinated and managed but whether it rises to the level of the standard set out by the court in *General Motors* is another question. As noted above, "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dept. of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). Despite Taxpayer's objections, the Department is unable to agree that it has demonstrated that the audit – which was based upon an onsite review of Taxpayer's food production facility – was wrong and that it is entitled to claim to the exemption.

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

Taxpayer has established that the "Deboning Conveyor Roller," "Neck Chiller Conduit Clamps," "Neck

Chiller," Defeather Sheaves," Thigh Deboning Conveyor," and "Hydraulic Conveyor Part," "Sodium Hypochlorite." and "Sodium Acid Sulfate" are exempt; in all other respects, Taxpayer's protest is denied.

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