

Letter of Findings Number: 04-20110065
Sales and Use Tax
For Tax Years 2007 and 2008

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ISSUE

I. Sales and Use Tax—Imposition.

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](#); Indiana Dep't of Revenue v. Interstate Warehousing, Inc., 783 N.E.2d 248 (Ind. 2003); North Cent. Industries, Inc., Company v. Indiana Dep't of Revenue, 790 N.E.2d 198 (Ind. Tax Ct. 2003); Rotation Products Corp. v. Dep't of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998); Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

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

STATEMENT OF FACTS

Taxpayer, an Indiana company, is in the recycling business. Taxpayer operates a scrap yard where it collects scrap metal from its customers. Taxpayer then repackages the scrap metal in bales and sells the baled scrap metal to steel mills. The Indiana Department of Revenue ("Department") conducted a sales/use tax audit concerning Taxpayer's asset and expense purchases for tax years 2007 and 2008. Pursuant to the audit, the Department assessed Taxpayer additional use tax, interest, and penalty on several purchases of tangible personal property because Taxpayer did not pay sales tax at the time of the transactions nor did it self-assess and remit use tax to the Department.

Taxpayer timely protested the assessments. To support its protest, Taxpayer submitted additional documentation, including photos and video clips, demonstrating its uses of the tangible personal property. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax—Imposition.

DISCUSSION

The Department's audit assessed Taxpayer use tax on its purchases of tangible personal property. Taxpayer, to the contrary, claimed that it was entitled to statutory exemptions on certain tangible personal property. Specifically, Taxpayer asserts that it was entitled to the manufacturing exemption on its purchases of two cranes, a boom lift, and a wire stripper.

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 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. 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 Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96, 97 (Ind. Ct. App. 1974).

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.** (**Emphasis added**).

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. (**Emphasis added**).

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 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.

The exemption for direct consumption in production is further explained at [45 IAC 2.2-5-12](#), in part, as follows:

(a) The state gross retail tax shall not apply to sales of any tangible personal property consumed in direct production by the purchaser in the business of producing tangible personal property by manufacturing, processing, refining, or mining.

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

(c) The state gross retail tax does not apply to purchases of materials to be directly consumed in the production process or in mining, provided that such materials are directly used in the production process; i.e., they have an immediate effect on the article being produced. 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.

[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.

Before Taxpayer can benefit from the exemptions stated above, Taxpayer must meet the threshold question of whether Taxpayer's activities qualify as a manufacturing process. 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. **(Emphasis added)**.

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, in *Rotation Products Corp. v. Indiana Dep't of State Revenue*, 690 N.E.2d 795 (Ind. Tax Ct. 1998), has outlined the requirements when determining what constitutes manufacturing. In *Rotation Products*, the 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.

In the instant case, Taxpayer states that as a recycler it collects and bales scrap metal, such as empty beverage cans or discarded wires, to be sold to steel mills. Taxpayer's documentation demonstrates that it uses the cranes and boom lift to move the baled scrap metal on to the trucks which deliver the baled scrap metal to the steel mills. Taxpayer further explains that when the discarded wires contain coating materials, its employees need the wire stripper to remove the coating materials from the metal materials.

Thus, Taxpayer's documentation demonstrates that Taxpayer does not add new parts to the articles; in fact, Taxpayer merely separates and "repackages" the scrap metal. While Taxpayer's customers may prefer to purchase only in cubes or 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. Industries, 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.

Even if, *arguendo*, Taxpayer were producing scrap metal, Taxpayer's documentation demonstrates that it did not directly use the items in the direct production. As mentioned above, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable, unless the use of the tangible personal property satisfies the "double-direct" test; the equipment at issue must be involved in the direct production of the marketable goods and must have a direct effect upon that marketable goods.

In short, pursuant to the above mentioned statutes, regulations, and case law, Taxpayer's activities and its use of the tangible personal property do not qualify for the manufacturing exemption. Taxpayer should have paid sales tax on the items at the time of purchase. Since sales tax was not paid, use tax was properly imposed.

FINDING

Taxpayer's protest is respectfully denied.

