

Letter of Findings: 04-20110100
Sales and Use Tax
For the Years 2006, 2007, 2008, and 2009

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ISSUE

I. Sales and Use Tax – Manufacturing Exemption.

Authority: IC § 6-2.5-1-1 et seq.; IC § 6-2.5-1-2; IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-4-1; 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 Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); Rhoads v. Indiana Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); Indiana Dep't. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983); Mumma Bros. Drilling Co. v. Department of Revenue, 411 N.E.2d 676 (Ind. Ct. App. 1980); General Motors Corp. v. Indiana Dep't. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Department of Revenue, State of Indiana v. Kimball Int'l, Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988).

Taxpayer protests the assessment on purchases of tangible personal property.

STATEMENT OF FACTS

Taxpayer, an out-of-state company, has a facility in Indiana which assembles/manufactures engines. The Indiana Department of Revenue ("Department") conducted a Sales/Use tax audit for tax years 2006, 2007, 2008, and 2009. Due to the volume of Taxpayer's records, the Department and Taxpayer agreed to utilize a sample selected from Taxpayer's records and a projection method to perform the audit. Pursuant to the audit, the Department assessed additional use tax and statutory interest on Taxpayer's purchases of tangible personal property.

Taxpayer only protests the imposition of use tax on the materials it purchased for an HVAC air conditioning system ("HVAC system") which a contractor ("Contractor") installed in the Indiana facility. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Sales and Use Tax – Manufacturing Exemption.

DISCUSSION

The Department's audit assessed Taxpayer use tax on the materials used in the HVAC system, which the Contractor installed and Taxpayer paid, in eight (8) installments/invoices which were within the sample selected during the audit. The audit stated, in pertinent part, that:

In 2008, the taxpayer contracted with [Contractor], on a lump sum basis, to install an HVAC air conditioning system for its [Indiana facility]. The taxpayer presented an exemption certificate to [Contractor], claiming that the purchase of the HVAC air conditioning system is an exempt purchase per the manufacturing exemption.

Because, during the audit, Taxpayer was not able to obtain the original invoices to determine the correct use tax due, both Taxpayer and the Department agreed that, for all eight invoices, sixty (60) percent of the total charges represented materials and forty (40) percent of the total charges represented labor charges. The audit then proceeded to assess use tax on the charges for materials: sixty (60) percent of the total charges.

At the administrative hearing, Taxpayer first claimed that it is entitled to the manufacturing exemption on the HVAC system pursuant to IC § 6-2.5-5-3(b) and Indiana case law. Alternatively, Taxpayer asserted that, after the audit, Taxpayer was able to obtain the invoices showing that the Contractor billed materials (six invoices) and labor charges (two invoices) separately. Thus, Taxpayer maintained that the assessment should be readjusted to reflect the correct amount stated in the invoices for materials.

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 an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). "Use" means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The use tax is functionally equivalent to the sales tax. See Rhoads v. Indiana Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly

out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. *Id.*; *USAir, Inc. v. Indiana Dep't of State Revenue*, 623 N.E.2d 466, 468–69 (Ind. Tax. Ct. 1993). The use tax ensures that, after such goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. *Id.* A taxable retail transaction occurs when (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), (c); IC § 6-2.5-3-2(a).

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 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, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Id.* at 100-101.

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).**

Thus, the Legislature granted Indiana manufacturers a sales tax exemption for certain purchases, which are for "direct use in direct production, manufacture... of other tangible personal property." In enacting the exemption, the Legislature clearly did not intend to create a global exemption for any and all equipment which a manufacturer purchases for use within its manufacturing facility. "Fairly read, the exemption was meant to apply to capital equipment that meets the 'double direct' test." *Mumma Bros. Drilling Co. v. Department of Revenue*, 411 N.E.2d 676, 678 (Ind. Ct. App. 1980). The capital equipment "in order to be exempt, (1) must be directly used by the purchaser and (2) be used in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of tangible personal property." *Indiana Dep't. of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520, 525 (Ind. 1983). "The test for directness requires the equipment to have an 'immediate link with the product being produced.'" *Id.* Accordingly, the sales tax exemption is applicable to that equipment which meets the "double direct" test and is "essential and integral" to the manufacture of taxpayer's tangible personal property. *General Motors Corp. v. Indiana Dep't. of State Revenue*, 578 N.E.2d 399, 401 (Ind. Tax Ct. 1991). The application of Indiana's double-direct manufacturing exemptions often varies based on a determination of when a taxpayer's manufacturing process is considered to have begun and ended.

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 direct 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. (Emphasis added).

Additionally, [45 IAC 2.2-5-8](#) (j) provides:

Machinery, tools, and equipment used in managerial sales, research, and development, or other non-operational activities, are not directly used in manufacturing and, therefore, are subject to tax.

This category includes, but is not limited to, tangible personal property used in any of the following activities: management and administration; selling and marketing; exhibition of manufactured or processed products; safety or fire prevention equipment which does not have an immediate effect on the product; space heating; **ventilation and cooling for general temperature control**; illumination; heating equipment for general temperature control; and shipping and loading. **(Emphasis added).**

In RCA Corp., the taxpayer, RCA Corp., claimed that it purchased certain environmental control equipment, i.e., air conditioning equipment, to be directly used in the direct production of color television picture tubes, and, therefore, was exempt from sales/use tax. RCA Corp., 310 N.E.2d at 97-98. In making its case, RCA Corp. argued that the environmental control equipment was "used to control the temperature, humidity and presence of foreign particles in the air, in around and on the surface [sic] of color television picture tubes during the manufacturing process." Id. The trial court agreed with the RCA Corp., but the Indiana Court of Appeals ("RCA Court") disagreed. Reversing the trial court's decision, the RCA Court ruled in favor of the Department. Applying the "double direct standard," the RCA Court found that:

Whatever effect (whether positive or negative) that RCA's air conditioning or environmental control equipment may have on the tubes RCA manufactures, or on the process of their manufacture, is exerted through the

medium or agency of the environment (i.e., the air). The very name of the equipment, whether 'air conditioning' or 'environmental control', signifies that its immediate effect is on the surroundings in which the manufacturing process takes place and only remotely, through the intervening agency of those surroundings, on the tubes or on the process by which they are manufactured. Id. at 100.

The RCA Court thus determined that RCA Corp. was not entitled to the manufacturing exemption for its purchase of the environmental control equipment/air conditioning equipment.

The Indiana Court of Appeals subsequently addressed a similar issue, but on a very different set of circumstances, in *Department of Revenue, State of Indiana v. Kimball Int'l, Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988). In *Kimball*, the taxpayer, Kimball International, manufactured "finished wood products and components, including pianos, speaker cabinets and furniture." Id. at 455. Kimball International claimed that it was entitled to the manufacturing exemption on its purchases of "spray booths, air make up units, and their associated component parts." Id. Ruling in favor of Kimball International, the Indiana Court of Appeals ("Kimball Court") explained, in pertinent part, that:

The spray booth and air make up units come into play during the final phase of the manufacturing process, when the finish is applied. After the wood products are assembled and prepared, they are moved by conveyor into finishing rooms. The finishing rooms are isolated from the rest of each plant by separate walls and positive air pressure. The spray booths and air make up units are found inside the finishing rooms. The spray booths are three-sided structures and also include fans, water baths and duct work. The spray booths are designed so that overspray and evaporated solvents are exhausted from the finishing rooms through the water baths and duct work to the outside.

The air is exhausted from the finishing rooms at a rate of 120,000 cubic feet per minute, thus creating a need for an air in-take system. This is the function of the air make up units which include fans, filters, heaters and duct work. In addition to bringing in outside air, the air make up units heat the air and control its humidity. Id.

The Kimball Court, through expert testimony and exhibits, found that Kimball International used the spray booths and air make up units to prevent a "blushing" condition in the manufacturing process so its finished products can be "saleable." Id. The Kimball Court also found, in relevant part, that:

It was undisputed that collecting and removing the excess spray by use of the spray booths, spray booth coatings, water baths, and paint deflocculents is critical from a safety standpoint. The chemicals Kimball uses are highly flammable and without constant cleansing, the air in the finishing rooms would quickly become explosive.

It was also uncontroverted that the combination of the air make up units and the spray booths creates an airflow that is essential to the manufacturing process. This air movement promotes drying of the newly applied finish. Without this predrying a condition called "blistering" would occur during the later oven drying stage whereby trapped solvents would create bubbles in the finish. The airflow is also responsible for controlling sags and runs in the newly applied finish by improving the uniformity of the spray. Id.

The Kimball Court thus concluded that Kimball International met its burden of proof and was entitled to manufacturing exemption on its purchases of spray booths, air make up units, and the associated component parts.

In this instance, Taxpayer claims that it, like Kimball International, is entitled to the manufacturing exemption on its purchase/installation of the HVAC system for its Indiana facility pursuant to IC § 6-2.5-5-3(b). To support its protest, Taxpayer submitted photos illustrating its products (engine blocks/parts), the installation/use of the HVAC system, and the areas designated for the service area and storage of its finished products where the HVAC system was not installed. Taxpayer stated that, in 2007, it implemented Advanced Product and Quality Planning ("APQP") to improve the quality of the engines it manufactures/assembles and to satisfy the customers' specifications, which were "known within the industry as CPKs." Taxpayer asserted that, through its own internal study, it found that its production was often behind schedule during the summer periods. Referring to its documentation, Taxpayer explained that, pursuant to the APQP, it concluded that its production fell behind primarily due to temperature changes inside the facility because performing the machining operations took place "over a number of days, under changing temperatures from day-to-day or shift-to-shift (day-to-night)." Thus, Taxpayer maintained that "[t]he failure to control summer time temperature clearly had a significant negative impact on manufacturing level in prior years." Therefore, Taxpayer claimed that it was necessary to install the HVAC system and the HVAC system was directly used in its direct production pursuant to Kimball.

The Department must respectfully disagree. Taxpayer's reliance on Kimball is misplaced. Taxpayer's documentation showed that its production fell behind schedule not just during the summer periods. While there could be various reasons explaining why Taxpayer's production fell behind its schedule, they were beyond the scope of this protest.

Taxpayer claimed that there was no HVAC system for the non-production area, e.g., the service area and the storage area for finished product, and that the HVAC system was only installed in "the facility that houses the production and assembly areas where maintaining control of the temperature change components through the

production process is critical." Thus, Taxpayer's documentation demonstrated that its use of the HVAC system is more like RCA's use of the air conditioning equipment—to control the temperature during the manufacturing process. As the Department's audit noted, in pertinent part, that:

The manufacturing facility is not a climate controlled environment nor does the taxpayer's manufacturing process require a climate controlled environment. The manufacturing facility is an open facility with different aspects of the manufacturing process along with maintenance functions being conducted throughout open sections of the plant. The taxpayer's manufacturing process does not require a clean room facility....

The auditors toured the manufacturing facility on multiple occasions. Other than ear and eye protection, the auditors were not required to wear any other special clothing to enter the manufacturing facility. This facility does not contain any manufacturing that would represent clean room processes.

Thus, unlike the taxpayer's use of spray booths and air make up units in Kimball to prevent "blushing" and "blistering" in producing the saleable products, Taxpayer's use of the HVAC system, though arguably necessary, did not have a direct and/or an immediate impact on the engines it manufacturers/assembles. Rather, Taxpayer's use of the HVAC system is more like the taxpayer in RCA—to control the temperature inside its Indiana facility, which, in turns, reduce the claimed temperature fluctuation in order to achieve its desired CPKs. As [45 IAC 2.2-5-8\(g\)](#) explains "[t]he 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.'" Rather, "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." Id. Thus, given the totality of the circumstances, in the absence of other supporting documentation, the Department is not able to agree that Taxpayer has met its burden. Pursuant to Indiana statutes, regulations, and case law, Taxpayer thus is not entitled to the manufacturing exemption. Since Taxpayer did not pay sales tax on its purchase, use tax is properly imposed.

Nonetheless, Taxpayer's documentation demonstrates that the Contractor billed materials and labor charges separately pursuant to their agreement. Thus, with the properly documented six invoices for the charges of materials, the Department will recalculate the use tax on the materials based on Taxpayer's invoices.

FINDING

Taxpayer's protest is respectfully denied. However, with the properly documented six invoices for the charges of materials, the Department will recalculate the use tax due in a supplement audit.

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