

**Letter of Findings Number: 04-20120432**  
**Sales/Use Tax**  
**For Tax Years 2009-2011**

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**ISSUE**

**I. Sales/Use Tax—Utilities.**

**Authority:** IC § 6-8.1-5-1(c); IC § 6-2.5-2-1; IC § 6-2.5-5-1; IC § 6-2.5-3-2(a); Dep't of Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Indiana Dept't of State Revenue, Sales Tax Div. v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); [45 IAC 2.2-5-12](#); [45 IAC 2.2-4-13](#); [45 IAC 2.2-5-8\(g\)](#).

Taxpayer protests the proposed assessment of sales/use tax for natural gas.

**STATEMENT OF FACTS**

Taxpayer is a company that manufactures furniture products. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit for the tax years 2009 through 2011. As a result of the audit, the Department issued proposed assessments for use tax and interest. Taxpayer filed a protest with the Department. An administrative hearing was conducted and this Letter of Findings ("LOF") results. Further facts will be supplied as required.

**I. Sales/Use Tax—Utilities.**

**DISCUSSION**

At the outset, the Department notes that under IC § 6-8.1-5-1(c): "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

Pursuant to the Indiana Code, a sales tax ("gross retail tax") is imposed on retail transactions made in Indiana unless a valid exemption is applicable. IC § 6-2.5-2-1; IC § 6-2.5-5-1 et seq. Also, a complementary excise tax "known as the use tax, is imposed 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).

Taxpayer's protest letter states that Taxpayer is protesting "use taxes being assessed for natural gas being purchased from a public utility." Taxpayer's letter further states:

The natural gas being consumed on the main meter within our facility is used for three purposes: heating the building, finish ovens, and air makeup units (AMUs). During the audit, only the finish ovens were determined to be directly used in manufacturing and treated as exempt. This represents 10[percent] of the annual consumption of natural gas.

Regarding the natural gas purchased by Taxpayer, the Audit Report states:

The natural gas is purchased from a public utility. The taxpayer presented the auditor a study performed for 2011 showing how the natural gas is being used by the taxpayer. This study showed that 19[percent] of the gas is being used to heat the building, 10[percent] is being used in ovens which are drying the finish on the furniture during production and 71[percent] of the gas is used to heat the air being brought into the building by the air makeup units. The auditor has considered gas used for heating the building & the gas used to heat the air brought into the building by the air makeup units to be taxable. As such 90[percent] of the natural gas purchased is being taxed in this audit in accordance with [45 IAC 2.2-5-12](#). Only the ovens were determined to be directly used in manufacturing and exempt. (Emphasis added).

[45 IAC 2.2-5-12](#), the regulation cited to by the Auditor, states:

(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.

(d) Pre-production and post-production activities.

(1) Direct consumption 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 process has altered the item to its completed form, including packaging, if required.

(2) "Direct use in mining" begins with the drilling of the shaft or well or the first removal of overburden in surface mining or quarrying. It ends when the item being mined or extracted has been physically removed from the mine, well, or quarry.

(e) "Have an immediate effect upon the article being produced or mined." Purchases of materials to be consumed during the production or mining process are exempt from tax, if the consumption of such materials has an immediate effect upon the article being produced and mined, or upon machinery, tools, or equipment which are both used in the direct production or mining process and are exempt from tax under these regulations [\[45 IAC 2.2\]](#).

(f) Other taxable transactions. Purchases of materials consumed in manufacturing, processing, refining, or mining activities beyond the scope of those described in subsection B above [subsection (e) of this section] are taxable. Such activities include postproduction activities; storage step [sic.]; maintenance, testing and inspection (except where in direct production); (except where essential and integral to the process system); management and administration; sales; research and development; exhibition of products; safety or fire prevention; space heating; ventilation and cooling equipment for general temperature control; illumination; shipping and loading.

(g) "Consumed" as used in this regulation [\[45 IAC 2.2\]](#) means the dissipation or expenditure by combustion, use, or application and does not mean or include the obsolescence, discarding, disuse, depreciation, damage, wear or breakage of tools, dies, equipment, machinery, or furnishings.

And [45 IAC 2.2-4-13](#) states:

(a) In general, the furnishing of electricity, gas, water, steam, or steam heating services by public utilities to consumers is subject to tax.

(b) The gross receipt of every person engaged as a power subsidiary or a public utility derived from selling electrical energy, gas, water, or steam to consumers for direct use in direct manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in [IC 6-2.5-4-5](#) shall not constitute gross retail income of a retail merchant received from a retail transaction. Electrical energy, gas, water, or steam will only be considered directly used in direct production, manufacturing, mining, refining, oil or mineral extraction, irrigation, agriculture, or horticulture if the utilities would be exempt under [IC 6-2.5-5-1](#).

(c) Sales of public utility services or commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in [IC 6-2.5-4-5](#), based on a single meter charge, flat rate charge, or other charge, are excepted if such services are separately metered or billed and will be used predominantly for the excepted purposes.

(d) Sales of public utility services and commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, or horticulture, based on a single meter charge, flat rate charge, or other charge, which will be used for both excepted and nonexcepted purposes are taxable unless such services and commodities are used predominantly for excepted purposes.

(e) Where public utility services are sold from a single meter and the services or commodities are utilized for both exempt and nonexempt uses, the entire gross receipts will be subject to tax unless the services or commodities are used predominantly for excepted purposes. Predominant use shall mean that more than fifty percent (50[percent]) of the utility services and commodities are consumed for excepted uses.

Taxpayer, in follow-up correspondence to the Department states:

There was concern in the initial audit explanation that the finish process is not in a closed environment. Specifically, there are two separate concrete walled buildings ([]) within the main production facility where the finishing process occurs.

Taxpayer states that "a separate and distinct facility for finishing is not practical in any wood finishing operation." Furthermore, Taxpayer states:

Finish rooms must have positive air pressure applied to the area in order to prevent contaminants into the finished products, assist in finish chemical application and curing as well as to maintain building structure integrity. [Taxpayer's] finish process extracts over 242,000 cubic feet of air per minute during operation, which by the way, currently operates 5 1/2 hours per day due to low product demand. This air must be replaced through the air makeup units (AMU's). [Taxpayer's] AMU's have gas fueled heaters built into the system that are thermostatically controlled to operate at temperatures below 70 degrees so that the application temperature of the products are maintained to comply with the finish manufacturer's requirements.

...

Taxpayer also states:

[T]he fact that the AMU's are consuming gas in 10 of the last 12 months is a key fact to support the need for heating requirements to meet the finish requirements from the supplier. The AMU's thermostats run most mornings to offset the ambient temperature of the facility in order to produce saleable product without sags,

runs, cloudy or blushed characteristics, which are inherent if proper temperature and airflow throughout the finish application and curing processes is not followed.

Taxpayer in its protest cites to *Dep't of Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988), in support of its argument. The taxpayer in Kimball was "in the business of manufacturing finished wood products and components, including pianos, speaker cabinets and furniture." Id. at 455. Kimball claimed it qualified for the manufacturing exemptions for its "spray booth and air make up units" that were used "during the final phase of the manufacturing process, when the finish is applied." Id. Regarding the air make up units, the court noted:

The air make up units are responsible for maintaining the finishing room's positive air pressure, which prevents dust and other particles from entering the rooms and settling on the freshly applied finish. The air make up units also control the temperature and humidity in the room, which increases the air's capacity to absorb excess solvents. Without the temperature and humidity controls a condition called "blushing" would occur where the finish becomes cloudy and the product unsaleable.

*Id.* The Indiana Court of Appeals found that "Kimball qualified for the exemption." *Id.* at 457.

Taxpayer analogizes its operation with that of Kimball, with Taxpayer stating in its protest letter:

[Taxpayer's] finishing process, like the Kimball International decision allowing an exemption from the State Gross Retail Tax . . . requires over 242,000 CFM (cubic feet of air per minute) of air be exhausted from the room creating the need to offset this use in an economical and feasible technological fashion with AMUs. AMUs include fans, filters, heaters and duct work that must be operated all year long. The natural gas consumption is required when the inside temperature or humidity within the room exceeds the levels conducive for effective finish application to wood. Not enough ambient temperature or too high of humidity level does not allow the air to absorb the excess solvents applied within the finish process. When this occurs, products become cloudy and blushed making the products unsaleable.

Taxpayer states that it must "adhere within the finish manufacturer's temperature requirements." But the "Finishing Schedule" provided by Taxpayer does not put it in terms of a requirement, but as a recommendation:

The above finishing scheduled used with normal temperatures (70-80[degrees]F), humidity (50-60[percent]) and air flow is recommended. Variations in these conditions may result in improper cure. (Emphasis added).

The Department finds the recommendation quoted above to be different from the description of Kimball's process, where the Court stated:

[T]he evidence also supports the findings that without the equipment Kimball's entire process would be impossible from an operational standpoint and from the standpoint of safety.

Kimball, 520 N.E.2d at 457. (Emphasis added).

The Audit Report also states:

The air makeup units are not located in a closed room environment but the heated air travels throughout the plant. While it is true that the air makeup units are located in the finishing rooms of the plant, the air can travel from the finishing room to other parts of the plant. Openings are located at both ends of the finishing room with conveyors moving furniture in process from one part of the plant to another. These openings remain open at all times. The finishing room also has a dock door which opens to the outside of the building. As weather permits (warmer days) this outside dock door remains open in the finishing room.

The Department notes that in applying any tax exemption, the "general rule is that tax exemptions are strictly construed in favor of taxation and against the exemption." Kimball, 520 N.E.2d at 456. A statute which provides a tax exemption is strictly construed against the taxpayer. *Indiana Dep't of State Revenue, Sales Tax Div. 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 101 (quoting *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)).

Taxpayer has not established that without the air make up units a final marketable product could not be produced. The "Finishing Schedule" uses terms like "recommended" and "may;" it does not say required. As [45 IAC 2.2-5-8\(g\)](#) states, "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.'" And, as the quotation from the Audit Report makes clear, Taxpayer's air make up units "are not located in a closed room environment . . .".

## FINDING

Taxpayer's protest is denied.

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