

**Letter of Findings: 04-20140393**  
**Gross Retail Tax**  
**For the Years 2010, 2011, and 2012**

**NOTICE:** IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.

**ISSUE**

**I. Gross Retail Tax - Equipment Used in Direct Production.**

**Authority:** IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-2.5-3-1(a); IC § 6-2.5-3-2(a); IC § 6-8.1-5-1(c); IC § 6-2.5-5-3; IC § 6-2.5-5-3(b); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Rhoades v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-8\(a\)](#); [45 IAC 2.2-5-8\(c\)](#); [45 IAC 2.2-5-8\(d\)](#); [45 IAC 2.2-5-8\(g\)](#); [45 IAC 2.2-5-8\(k\)](#).

Taxpayer argues that certain items of equipment it purchased are exempt from sales/use tax because the equipment is directly used in the direct production of hot mix asphalt.

**STATEMENT OF FACTS**

Taxpayer is an Indiana business which manufactures asphalt and constructs roads. The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns. The audit resulted in the assessment of additional sales/use tax. Taxpayer disagreed with a portion of the assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

**I. Gross Retail Tax - Equipment Used in Direct Production.**

**DISCUSSION**

Taxpayer is in the business of building highways. To that end, it owns and operates Indiana asphalt plants. According to Taxpayer, "[I]t produces hot mix asphalt for its use in projects on which it is contracted, but also sells asphalt mix to outside customers, cities and towns for their private use."

The Department's audit reviewed Taxpayer's production process and found that certain items of Taxpayer's equipment were not exempt from sales tax. Taxpayer disagrees with a portion of the audit's conclusion, arguing that a cold feed system and asphalt grinder are essential and integral to the production of hot mix asphalt.

**A. Burden of Proof.**

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." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Thus, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012).

**B. Indiana Sales and Use Tax.**

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).

In effect and practice, the use tax is functionally equivalent to the sales tax. See *Rhoades v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

Taxpayer is in the business of constructing roads and producing hot mix asphalt. The general rule is that all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property - such as hot mix asphalt - are taxable. [45 IAC 2.2-5-8\(a\)](#).

### C. Manufacturing Exemption.

As authority for its conclusion that its asphalt grinder and cold feed system are exempt, Taxpayer cites to IC § 6-2.5-5-3, which states in part:

(b) Except as provided in subsection (c), 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.

(c) The exemption provided in subsection (b) does not apply to transactions involving distribution equipment or transmission equipment acquired by a public utility engaged in generating electricity.

The Department's regulation, [45 IAC 2.2-5-8](#), explains that a taxpayer is entitled to purchase machinery, tools, and equipment without payment of the gross retail tax when the equipment is used in the direct production of tangible personal property. [45 IAC 2.2-5-8\(a\)](#) emphasizes that the exemption is limited to that equipment "directly used by the purchaser in direct production." [45 IAC 2.2-5-8\(c\)](#) specifies that "directly used" means that the equipment has "an immediate effect on the article being produced." Refining the definition further, the regulation states that "[p]roperty 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." *Id.* See IC § 6-2.5-5-3(b). However, it should also be noted that "[t]he fact particular property may be considered essential to the conduct of the business of manufacturing because its use is required . . . by practical necessity does not mean itself that the property 'has an immediate effect upon the article being produced.'" [45 IAC 2.2-5-8\(g\)](#).

Proper application of this particular exemption requires determining at what point "production" begins and at what point "production" ends. [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.

In addition, [45 IAC 2.2-5-8\(c\)](#) requires that exempt equipment must have an immediate effect on the product being produced:

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.

Finally, [45 IAC 2.2-5-8\(k\)](#) specifies that, in order to qualify for the exemption, the articles being produced have undergone a "substantial change."

"Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance as a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition,

or character must be a substantial change, and it must result in a transformation of property into a different product having a distinctive name, character, and use. Operations such as compounding, fabricating, or assembling are illustrative of the types of operations which may qualify under this definition.

To summarize, machinery, tools, and equipment purchased for use in the production of goods are subject to use tax unless the property used has a direct and immediate effect on the goods produced and is essential to an integrated process used to produce those marketable goods.

The issue is whether the specific items of equipment are exempt on the ground that these items of equipment are "directly used by the purchaser in the production process [because] they have an immediate effect on the article being produced." [45 IAC 2.2-5-8\(c\)](#).

### **1. Asphalt Grinder.**

The Department's audit found that Taxpayer's purchase of an asphalt grinder was subject to sales/use tax. Taxpayer disagrees describing the device as a "milling machine" necessary and integral to the production of hot mix asphalt.

These machines use a large rotating drum for removing and grinding the road surface. The drum consists of scrolls [] that are positioned around the drum such that the ground pavement is moved toward the center and can be loaded onto the machines [sic] conveyor belt. Milling is used for pavement recycling, where the pavement is removed and ground up to be used as the aggregate in new pavement. Milled material . . . becomes the property of the contractor . . . . For asphalt surfaces, the product of milling is reclaimed asphalt pavement . . . which can be recycled in the [] hot mix asphalt.

Taxpayer concludes that its grinder produces a raw material for use in the production of other tangible personal property and that the asphalt grinder - along with supplies associated with maintaining the device - are exempt pursuant to IC § 6-2.5-5-3(b).

Taxpayer explains:

In order to produce asphalt . . . we purchase raw materials in the form of aggregates (stone) and liquid asphalt. We also crush asphalt we have removed from roadways/[parking] lots for inclusion back into the new asphalt as that is a cost saver for us as the liquid asphalt costs anywhere from \$450-\$650 per ton and the crushed asphalt has a liquid content to it therefore decreasing the need for as much raw liquid material in the mix.

The Department is unable to agree that the asphalt grinder is directly used in the direct production of Taxpayer's hot mix asphalt. The recovery of asphalt from roads and parking lots results in materials which are used in the production of the hot mix asphalt but the asphalt grinder is at least one step removed in both time and space from the integrated process which results in Taxpayer's saleable product. The asphalt grinder may well be essential to the ultimate production of hot mix asphalt, but - as [45 IAC 2.2-5-8\(g\)](#) specifies - "[t]he fact particular property may be considered essential to the conduct of the business of manufacturing because its use is required . . . by practical necessity does not mean that the property 'has an immediate effect upon the article being produced.'" [45 IAC 2.2-5-8\(g\)](#).

### **2. Cold Feed System.**

Taxpayer purchased a "Six-Compartment Cold Feed System." The audit found that the "cold feed system" was subject to tax because "no mixing [is] being done in the cold feed bins; the dry materials are just placed there because a control system is set in place that drops the appropriate amounts of dry materials onto conveyor belts." The audit report continues:

At the beginning of the conveyor belt is where the weighing takes place, [and] this starts the manufacturing process.

Taxpayer argues that its purchase of a "cold feed system" was exempt from sales/use tax and that the "auditor misunderstands the process and function of the bins."

The cold feed system Taxpayer purchased consists of a series of six elevated bins mounted on steel legs, a thirty-inch belt feeder, a replacement thirty-inch belt, steel bulkheads, partitions, "bin vibrator," electric motor,

limiting switches, electric switches, computer controls, and assorted electrical equipment. The bins are open at the top to allow Taxpayer to load mixtures of various grades of sand, aggregate, rock, and other materials depending on the requirements of each customer. Underneath the six bins is a continuous belt on which is deposited a mixture of the various materials in the six bins. The output of each bin is computer controlled to assure that the resulting mixture of the materials matches the cold feed percentages of each particular job order. When combined, the materials are introduced into that portion of the plant which heats and further combines the ingredients.

As Taxpayer explains:

When it is determined what kind of mix is required for a project or projects the plant operator in the control building will select the mix number from a selection of mixes with established formulas and enter that into the computerized system . . . . One bin will contain a large aggregate, the next a slightly smaller aggregate, various types of sand and so on down the line . . . . Based upon the formula for the mix the computer controls openings at the bottom of the bins which open to allow a selected amount of material onto a continuously running belt immediately below the opening in the bin(s). This belt(s) transfer the various aggregate materials to the opening in a large drum which, like a concrete truck is continuously turning.

Taxpayer purchased the "cold feed system" from a vendor which is in the business of designing, building, and supplying such specialized devices. As explained in this vendor's description of this device, the cold feed systems are designed to "assure accurate mix formulas with [vendor] variable speed belt feeders. They let you change the [hot mix] production rate while keeping the mix formula unchanged."

The Department agrees that Taxpayer has met its burden of demonstrating that the cold feed system is an integral part of Taxpayer's production of hot mix asphalt, that production of these materials begins at this device, that the cold feed system has a direct and substantial effect on the hot mix asphalt ingredients, and that the system produces a result which is distinguishable from the original ingredients. However, it is important to note that the bins are not exempt due solely to the fact that they contain Taxpayer's gravel, sand, and aggregate; storage bins alone are treated as "pre-production" equipment. Similarly, the conveyor belt is not exempt due solely to the fact that it transports raw material prior to introduction into the hot mix system; without more, transporting raw materials into a production process is also properly categorized as "pre-production." The cold system - including the bins and conveyor belt - is exempt because it was designed, purchased, and functions as a single device within an integrated system which operates within Taxpayer's production process and because it has an immediate, substantial, and direct on the constituent components of the hot mix asphalt.

#### **D. Conclusion.**

Taxpayer's asphalt grinder is not exempt from sales tax. However, the cold feed system is exempt. There is insufficient information to determine what parts are or are not related to exempt equipment and this Letter of Findings does not address that issue.

### **FINDING**

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

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