DEPARTMENT OF STATE REVENUE

04-20140528.LOF

Letter of Findings: 04-20140528
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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Glass Manufacturer failed to establish that its rental of forklifts and fuel was exempt from sales tax because the forklifts were not directly used in the direct production of the Manufacturer's containers. Manufacturer was not entitled to an exemption on the purchase of a back-up electrical generator because the generator was not directly used in direct production. Water treatment chemicals were exempt because the treatment of the Manufacturer's discharge water was required by municipal ordinance.

ISSUES

I. Gross Retail Tax - Production Machinery, Supplies, and Equipment.

Authority: IC § 6-2.5-1-2; 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 § 6-2.5-4-1(b); IC § 6-2.5-5-3; IC § 6-2.5-5-3(b); IC § 6-8.1-5-1(c); Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Conklin v. Town of Cambridge City, 58 Ind. 130 (1877); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Rhoade 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); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); 45 IAC 2.2-5-8; 45 IAC 2.2-5-8(a); 45 IAC 2.2-5-8(b); 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); 45 IAC 2.2-5-10(g); 45 IAC 2.2-5-12(f).

Taxpayer argues that it is entitled to a refund of sales tax paid on the purchase of certain items of equipment and machinery which are used in either its production process or consumed in that process.

II. Gross Retail Tax - Environmental Regulation Compliance.

Authority: IC § 6-2.5-1-1 et seq.; IC § 6-2.5-5-30; IC § 6-8.1-5-1(b); 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); 45 IAC 2.2-5-70(a); Lapel, Ind. Ordinances 5-1979(e)(7)(i).

Taxpayer maintains that it is entitled to a refund of sales tax paid on the purchase of certain chemicals on the ground that the chemicals are necessary to comply with local, state, or federal environmental regulations.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of producing and selling glass containers. Taxpayer operates an Indiana manufacturing facility.

The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer's business records including records related to payment of sales and use tax. The audit resulted in the assessment of additional sales/use tax. Taxpayer paid the tax assessed.

However, Taxpayer disagreed with a portion of the original assessment and submitted a protest to that effect. Taxpayer argued that certain items of equipment, tools, and supplies were exempt and that it had incorrectly paid sales tax at the time the items were initially purchased.

I. Gross Retail Tax - Production Machinery, Supplies, and Equipment.

DISCUSSION

Taxpayer argues it was not subject to sales tax on the purchase of certain equipment, supplies, tools, materials, and machinery which it uses to produce its glass containers.

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). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014). Thus, interpretations of Indiana tax law contained within this decision, as well as the preceding audit, are entitled to deference.

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 generally functionally equivalent to the sales tax. See Rhoade 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. at 1048; USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466, 469 (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. IC § 6-2.5-3-2(a). 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), IC § 6-2.5-3-2(a).

As authority for its conclusion that its equipment, supplies, tools, materials, and machinery are exempt, Taxpayer cites to the Department's regulation, 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.
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> (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 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 must have undergone a "substantial change."

> "Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance of a 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.

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 Rev. v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). 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 101 (citing Conklin v. Town of Cambridge City, 58 Ind. 130, 133 (1877)). Nevertheless, the Department is well aware of the countervailing rule that a "statute must not be construed so narrowly that it does not give effect to legislative intent because the intent of the legislature embodied in a statute constitutes the law." General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991).

To summarize, machinery, tools, and equipment purchased or consumed in the production of goods are subject to sales or 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 and supplies Taxpayer purchased are exempt because these items are "directly used in the production process and because they have an immediate effect on the article being produced." IC § 6-2.5-5-3(b).

A. Forklifts.

Taxpayer's glass containers are manufactured using a combination of raw materials, post-consumer (recycled) glass, and "cullet." The raw materials consist of sand, limestone, and soda ash. The post-consumer materials consist of glass containers which were used by consumers, recycled, and reintroduced at the beginning of the production. "Cullet" consists of broken glass scraps which are collected and reintroduced during the production process.

Taxpayer argues it was not subject to tax on forklift rentals because the forklifts are directly used within its glass production process. In the case of the NMHG forklifts, Taxpayer explains that these rental forklifts are used in its facility which produces glass bottles. According to Taxpayer, "[O]nly forklift[s] purchased from NMHG were charged to the Batch & Furnace cost center were protested for refund." Taxpayer's plant manager states in writing that these forklifts "are exclusively used to move broken and/or rejected glass ("cullet") from the processing line back to the furnace to be re-introduced into the manufacturing process."

Based on the information provided, the Department does not agree that the forklifts were acquired - or rented - for

"direct us in the direct production" of Taxpayer's glass products. IC § 6-2.5-5-2(a). The forklifts at issue gather the cullet - now materials to be used in production - to reintroduce the cullet to another, new round of production. As such, the forklifts are being used to gather cullet in a new pre-production process and are therefore not exempt. The cullet, having fallen out of an integrated production process, becomes raw material transported in a preproduction step by the forklifts to a new, integrated production process.

The Department does not minimize the Taxpayer's reliance on the forklifts in its manufacturing facility. However as 45 IAC 2.2-5-10(g) provides, "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, of itself, mean that the property "acts upon and has an immediate effect on the tangible personal property being processed or refined."

B. Diesel Fuel.

Taxpayer purchased diesel fuel from "Hamilton County Coop Assn Inc." and charged those costs to its "Batch & Furnace" cost center. According to the Taxpayer's plant manager, the fuel charged to this cost center "is used exclusively to power the forklifts used to move the in-process materials . . . ." In its written protest, Taxpayer explains that fuel is used in forklifts which "move broken or rejected glass to be reintroduced into the [manufacturing] process. Taxpayer necessarily relies on 45 IAC 2.2-5-10(c) which provides:

> 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.

As explained above in "Part A," because the Department does not agree that its forklifts act within the integrated production process or that they have an immediate effect on the production of Taxpayer's final product, the fuel used to power those forklifts is not exempt. The diesel fuel does not have an immediate effect on Taxpayer's glass products and is not consumed in the "integrated process" which produces those containers.

C. Back-up Generator.

Taxpayer purchased a generator which it believes is exempt from sales tax. Taxpayer explains that the device is installed at its "cooling tower" facility and is "used whenever the power is interrupted to the cooling tower." Taxpayer explains that the "generator supplements power to the recirculating/water cooling tower pump that provides process water to all pieces of equipment that require cooling water."

Based on Taxpayer's description, the Department does not agree that Taxpayer established that the generator is exempt because the water cooling facility and its ancillary equipment is not "directly used by the purchaser in the director production, manufacture, fabrication, assembly, or finishing of tangible personal property." 45 IAC 2.2-5-8(b). Needless to say, the cooling tower and its backup generator may very well be "essential to the conduct of manufacturing" but although required by "practical necessity," there is no indication that the cooling equipment "has an immediate effect upon the article being produced." 45 IAC 2.2-5-8(g).

D. Repair Parts and Supplies.

Taxpayer maintains that certain items such "boring bars, inserts, tool holders, fabricated steel," and the like are exempt because the items were purchased for use in its glass production facility. The Department does not agree that Taxpayer has met its burden of establishing that these items are exempt. The items may very well be necessary, but there is nothing which clearly establishes that the items are directly used in the production of Taxpayer's glass products. Given that the exemption on which Taxpayer relies is "narrowly construed" and that Taxpayer has the burden of establishing that the proposed assessment is "wrong," the Department does not agree that the items are exempt from tax.

FINDING

Taxpayer's protest is respectfully denied.

II. Gross Retail Tax - Environmental Regulation Compliance.

DISCUSSION

The issue whether Taxpayer's two purchases of "Pollution Control Chemicals Used to Treat Water" are exempt from sales or use tax on the ground that the chemicals are necessary to comply with local, state, or federal environmental regulations.

As noted more completely in Part I above, tax assessments are presumed to be accurate; the Taxpayer bears the burden of proving that an assessment is incorrect. IC § 6-8.1-5-1(b).

Indiana imposes a sales tax on retail transactions and a complimentary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq. However, Indiana law allows manufacturers an exemption for items which are purchased for the purpose of complying with environmental quality standards.

The exemption is set out in IC § 6-2.5-5-30 which states in part that, "Sales of tangible personal property are exempt from the state gross retail tax if . . . the property constitutes, is incorporated into, or is consumed in the operation of, a device, facility, or structure predominately used and acquired for the purpose of complying with any state, local, or federal environmental quality statutes, regulations, or standards . . . ." The Department's regulation restates the exemption as follows:

> The state gross retail tax does not apply to sales of tangible personal property which constitutes, is incorporated into, or is consumed in the operation of, a device, facility, or structure predominately used and acquired for the purpose of complying with any state, local or federal environment [quality] statutes, regulations or standards; and the person acquiring the property is engaged in the business of manufacturing, processing, refining, mining, or agriculture.
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> (1) Consumed as used in this regulation . . . 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, machinery, devices or furnishings.
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> (2) Incorporated as used in this regulation . . . means the material must be physically combined into and become a component of the environmental quality device, facility, or structure. The material must constitute a material or integral part of the finished product. 45 IAC 2.2-5-70(a).

As noted previously, IC § 6-2.5-5-30, like all tax exemption provisions, is 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).

In this instance, Taxpayer cites to Lapel, Ind. Ordinances 5-1979(e)(7)(i). The provision states:

> Industrial cooling water, which may be polluted with insoluble oils or grease or suspended solids, shall be pretreated for removal of pollutants and the resultant clearer water shall be discharge in accordance with (h).

The ordinance places on Taxpayer the responsibility for treating its facility's discharged cooling water. The Department agrees that the purchase of the chemicals falls within the exemption provided under IC § 6-2.5-5-30 because the chemicals are required under the local municipal ordinance.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer is not entitled to a sales tax exemption on the purchase or rentals of forklifts used in batch and furnace facility or the purchase of diesel fuel used in those forklifts. Taxpayer is not subject to sales tax on chemicals required to comply with Lapel's environmental ordinance.

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