

**Letter of Findings: 04-20150287
Sales and Use Tax
For the Year 2011**

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Soil processor provided sufficient documentation to demonstrate it is eligible for the manufacturing exemption under IC § 6-2.5-5-3 regarding tangible personal property directly used in soil processor's integrated process.

ISSUES

I. Use Tax - Imposition.

Authority: IC § 6-2.5-5-3; IC § 6-2.5-3-2; IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-9](#); [45 IAC 2.2-3-14](#); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); 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. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); Indiana Dep't of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282 (Ind. Tax Ct. 1999); Mynsberge v. Indiana Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); North Cent. Industries, Inc. v. Indiana Dep't of State Revenue, 790 N.E.2d 198 (Ind. Tax Ct. 2003); Indiana Dep't of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983).

Taxpayer protests the assessment of use tax.

II. Use Tax - Shipping Materials.

Authority: IC § 6-2.5-5-9; [45 IAC 2.2-5-16](#).

Taxpayer protests use tax imposed on shipping materials.

III. Sales/Use Tax - Refund Claims.

Authority: IC § 6-2.5-5-3; IC § 6-8.1-5-1.

Taxpayer protests the refund claims denied in the audit report.

STATEMENT OF FACTS

Taxpayer is in the business of excavating and processing reed sedge peat ("Peat"). Taxpayer's business is located in Indiana. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of the company for the tax year 2011. The Department imposed use tax on items upon which sales tax was not paid at the time of purchase and then used by Taxpayer in Indiana. Taxpayer also had filed a refund claim that the audit report addressed and denied in part. Taxpayer protests the Department's assessment and partial refund denial. An administrative hearing was held. This Letter of Finding ensues. Additional facts will be provided as necessary.

I. Use Tax - Imposition.

DISCUSSION

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). Further, when an agency is charged with enforcing a statute, the courts defer to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Indiana Dep't 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.

IC § 6-2.5-5-3 states that "transactions involving manufacturing machinery, tools, and equipment are exempt from [sales tax] if the person acquiring that property acquires it for the direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property." ("Manufacturing exemption"). The issue in this instance is whether Taxpayer is a processor and is thus entitled to the manufacturing exemption for sales tax on items purchased for the direct use in the direct production of tangible personal property ("TPP") under IC § 6-2.5-5-3. During the audit, the Department determined that Taxpayer is a wholesale distributor of soils and various landscape materials. The audit report stated that "the activities associated with potting soil products, these products qualify for some manufacturing exemptions pursuant to [45 IAC 2.2-5-8](#)." The audit did exempt seven percent equipment used to manufacture potting soil and three percent toward front end loaders used to manufacture potting soil. Taxpayer disagreed and stated that drying, bagging, loading, and palletizing all its products are an integral production process and are entitled to the processing exemption for sales tax on items purchased.

Indiana imposes a 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). IC § 6-2.5-5-3(b) provides an exemption from sales tax for "manufacturing machinery, tools, and equipment . . . if the person acquiring the property acquires it for direct use in the direct production [or] manufacture . . . of other tangible personal property. . . ." Under [45 IAC 2.2-3-14\(2\)](#) exemptions that apply to IC § 6-2.5-5 also apply to use tax.

Generally, all purchases of TPP "by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable", unless specifically exempt by a statute. [45 IAC 2.2-5-8\(a\)](#). 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 (quoting *Conklin v. Town of Cambridge City* (1877), 58 Ind. 130, 133). Thus, in applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dep't of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). The exemptions to which Taxpayer aspires, like all tax exemption provisions, are 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. Indiana Dep't of State Revenue*, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999).

Thus, to determine whether Taxpayer is a processor, the Taxpayer must prove that the Peat goes through a substantial change and creates a new marketable product. The Department refers to [45 IAC 2.2-5-8\(k\)](#) which 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. The change must be substantial resulting in a transformation of the property into a different and distinct product. *Id.*

The Department turns to IC § 6-2.5-5-3(b) to determine whether Taxpayer's machines are exempt under the manufacturing exemption, which in relevant part, provides:

[T]ransactions 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).

[45 IAC 2.2-5-8\(b\)](#) notes:

The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of

tangible personal property.

Property acquired for "direct use in the direct production" is defined in [45 IAC 2.2-5-8\(c\)](#) as "manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process" that have "an immediate effect on the article being produced." Property has "an immediate effect" when it becomes "an essential and integral part of an integrated process which produces tangible personal property." [45 IAC 2.2-5-8\(c\)](#).

[45 IAC 2.2-5-8\(g\)](#) 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).**

The Indiana Tax Court explained in *North Cent. Industries, Inc. v. Indiana Dep't of State Revenue*, 790 N.E.2d 198, 200 (Ind. Tax Ct. 2003):

To qualify for the equipment exemption, North Central must show, in part, that it is engaged in the direct production or manufacture of other tangible personal property. **If it satisfies this element, North Central must then show that the equipment for which it seeks an exemption is directly used in the production of the tangible personal property.**

Although "[t]here are innumerable ways to produce other tangible personal property, [Indiana Code Section 6-2.5-5-3] cannot be expected to give a precise answer to each factual situation that arises." **Nevertheless, the Department's rules make clear that production must entail a "substantial" change or transformation that "places tangible personal property in a form, composition, or character different from that in which it was acquired."** Moreover, production must increase the number of "scarce economic goods," i.e., it must create a new, marketable product.

(Emphasis added)(Internal citations omitted).

In *Indiana Dep't of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983), the taxpayer engaged in mining and claimed that it was entitled to the sales tax exemption under the manufacturing exemption for trucks that haul crude stone. *Id.* The Indiana Supreme Court determined that the trucks themselves do not have to transform the crude stone in order to be exempt; it is enough that the item plays "an integral part of the ongoing process of transformation." *Id.* at 524.

Furthermore, [45 IAC 2.2-5-9](#) states:

- (a) In general, all purchases of tangible personal property by persons engaged in extraction or mining are taxable. The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to manufacturing machinery, tools, and equipment directly used in mining or extraction. It does not apply to materials consumed in mining or extraction.
- (b) The state gross retail tax shall not apply to sales of manufacturing machinery, tools, and equipment which are to be directly used by the purchaser in extraction or mining.
- (c) Manufacturing machinery, tools, and equipment to be directly used by the purchaser in the extraction or mining process are exempt from tax provided that such machinery, tools and equipment are directly used in the production process; i.e., they have an immediate effect on the item being produced by mining or extraction. 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.
- ...
- (e) Equipment directly used in extraction or mining: Manufacturing machinery, tools, and equipment used directly in the mining or extraction process are taxable unless the machinery, tools, and equipment have an immediate effect upon mining or extracting the product. The fact that particular property may be considered essential to the conduct of the business of mining because its use is required either by law or practical necessity does not, of itself, mean that the property has an immediate effect upon the mining or extracting of

the product. Instead, in addition to being essential for one of the above reason [sic], the property must also be an integral part of an integrated process.

...
(2) Examples of exempt machinery, tools, and equipment: digging and extracting equipment used in the course of mining or extraction operations; machinery used to remove the overburden in surface mining; blasting and dislodging equipment; waste extraction and removal equipment and machinery used in the course of mining or extraction operations; derricks, pumps, pump houses, drilling rigs used in the production of oil and natural gas.

In this instance, it is clear that the Peat is sold in a manner different from which it was acquired. Taxpayer has provided sufficient documentation to demonstrate that it turns a nonmarketable product into a scarce [sic] marketable economic good. Since it has been determined that the Peat undergoes a change pursuant to [45 IAC 2.2-5-8\(k\)](#), the next step is to determine Taxpayer's integrated process.

Taxpayer begins with an open field harvesting of Peat, which is a fibrous material which needs to be broken down into manageable pieces. Taxpayer drains and pumps water out of the field to allow the Peat to dry. Taxpayer then excavates the material. The material is strategically placed into domed hills to allow the Peat to dry. The material is rotated so that the bottom of the dome can dry too. When the material is dry it is transported to the facility.

Once at the facility the material is piled into a dome shape outside the plant to prevent precipitation from accumulating on the material. Casting sand is added to the Peat when it is ready for bagging. Taxpayer explained that because the Peat is so light in weight, casting sand is used to increase the weight of the material so it can fit into a manageable 40 pound material bag. Once material is dry and mixed it is loaded onto a soil grinder and screener. The grinder helps crush the material and the screen helps to remove foreign material such as wood or stone.

After the material has been ground and screened it either goes to have additional plant nutrients added or straight to bagging. The front loader places the material into the hopper for one final screening and drops the material into a volumetric feeder which measures out the material and drops it into a chute and funnels into a bag and is sealed. The bags are placed on to a pallet and shipped per customer requirements.

In this instance, Taxpayer's process begins with the process of excavation. The excavation process includes draining the bog before any Peat is removed pursuant to [45 IAC 2.2-5-9](#). Taxpayer's process ends with the sealing of the bag. Thus, Taxpayer met its burden showing it is engaging in excavating and process and provided documentation to show Taxpayer's integrated process. Therefore Taxpayer is entitled to the manufacturing exemption under IC § 6-2.5-5-3(b) for qualified items. A supplemental audit will review each protested item to determine whether a particular item is used in Taxpayer's integrated process as described above.

FINDING

Taxpayer's protest is sustained subject to a supplemental audit.

II. Use Tax - Shipping Materials.

Taxpayer protested use tax assessed on shipping materials. Taxpayer argued that the shipping materials are necessary to its integrated process. Also Taxpayer argued that the shipping materials were necessary per customer specifications. To determine whether Taxpayer's shipping materials are exempt the Department turns to the below referenced statute and regulation.

IC § 6-2.5-5-9 for the relevant year states:

- (a) As used in this section, "returnable containers" means containers customarily returned by the buyer of the contents for reuse as containers.
- (b) Sales of returnable containers are exempt from the state gross retail tax if the transaction constitutes selling at retail as defined in [IC 6-2.5-4-1](#) and if the returnable containers contain contents.
- (c) Sales of returnable containers are exempt from the state gross retail tax if the containers are transferred empty for the purpose of refilling.
- (d) Sales of wrapping material and empty containers are exempt from the state gross retail tax if the person acquiring the material or containers acquires them for use as nonreturnable packages for selling the contents that he adds.

[45 IAC 2.2-5-16](#) further explains:

- (a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers sold empty for refilling.
- (b) In general the gross proceeds from the sale of tangible personal property in a transaction of a retail merchant constituting selling at retail are taxable. This regulation [\[45 IAC 2.2\]](#) provided an exemption for wrapping materials and containers.
- (c) General rule. The receipt from a sale by a retail merchant of the following types of tangible personal property are exempt from state gross retail tax:
 - (1) Nonreturnable containers and wrapping materials including steel strap and shipping pallets to be used by the purchaser as enclosures for selling tangible personal property.
 - (2) Deposits for returnable containers received as an incident to a transaction of a retail merchant constituting selling at retail.
 - (3) Returnable containers sold empty for refilling.
- (d) Application of general rule.
 - (1) Nonreturnable wrapping material and empty containers. To qualify for this exemption, nonreturnable wrapping materials and empty containers must be used by the purchaser in the following way:
 - (A) The purchaser must add contents to the containers purchased; and
 - (B) The purchaser must sell the contents added.

Taxpayer has provided sufficient documentation to establish that the shipping materials are nonreturnable containers. The machines used to ship the Peat or wrap it are not exempt. The statute and regulation clearly exempt only the material and not the machines. Furthermore, Taxpayer's use of forklifts to move packaged pallets to storage or the shipping area is considered post production and not part of Taxpayer's "integrated process."

FINDING

Taxpayer's protest for shipping material is sustained, and is denied for the packaging machines.

III. Sales/Use Tax - Refund Claims.

Taxpayer filed four refund claims that were addressed in the audit report. Some of the claims were for years outside this decision; therefore only the items presented in the claims for the year at issue, 2011, will be discussed. Taxpayer requested a refund for sales tax paid on diesel fuel, dyed diesel fuel, propane, forklift rentals, and concrete blocks/stone. The audit report denied the refund claims because Taxpayer did not meet the exemption requirements under IC § 6-2.5-5-3.

As stated above in Issue I Taxpayer is entitled to the sales tax exemption under IC § 6-2.5-5-3 for TPP that is "essential and integral" to Taxpayer's ongoing process. Thus, for the forklift rentals, dyed diesel fuel, diesel fuel, and propane *[sic]* products will be exempt as long as the items are used during Taxpayer's integrated process. Pre-production and post-production usage will not be exempt. The only item not addressed in Issue I were the concrete blocks. The audit report explained that the stone purchased for resale was considered exempt. However, the stone/concrete blocks used for structural purposes are not exempt; the stone/blocks do not fall under Taxpayer's "integrated process." Thus, Taxpayer did not meet its burden under IC § 6-8.1-5-1(c) for proving the concrete blocks/stone as exempt.

FINDING

Taxpayer's protest is sustained in part, but denied in part for the concrete blocks/stone used for structural purpose is denied.

SUMMARY

For Issue I, Taxpayer is sustained, subject to a supplemental audit. The supplemental audit will determine which items are used in Taxpayer's integrated audit, given the new documentation presented to the Department. For Issue II, Taxpayer is sustained for the nonreturnable containers and shipping material but not for the machinery used in shipping. For Issue III, Taxpayer is sustained except for the concrete blocks/stone used for structural purposes.

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