

Letter of Findings 04-20150376
Use Tax
For the Years 2012-2014

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Rebar fabricator provided enough information to show that most of the Department's assessments of use tax were incorrect. Fabricator however could not prove the assessment of the Tractor Spotter, Software, or Coolant incorrect and was liable for the tax imposed.

ISSUE

I. Use Tax - Imposition.

Authority: IC § 6-2.5-5-3; IC § 6-2.5-1-24; IC § 6-2.5-3-2; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-12](#); [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); Mechanics Laundry & Supply, Inc. v. Indiana Dep't of State Revenue, 650 N.E.2d 1223 (Ind. Tax Ct. 1995); Black's Law Dictionary 1050 (9th ed. 2009).

Taxpayer protests the assessment of use tax.

STATEMENT OF FACTS

Taxpayer is a rebar fabricator in Indiana. According to Taxpayer's July 20, 2015 email, Taxpayer buys rebar in straight stock lengths and cuts and/or bends it according to their customers' needs. These products are incorporated into bridges, silos, concrete barriers, etc. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of the company for the tax years 2012-2014. The Department imposed use tax on items used by Taxpayer in Indiana.

Taxpayer protests most items in the audit claiming the items are exempt from use tax as part of an industrial production process. 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.

The issue in this instance is whether Taxpayer's process rises to the level of industrial production and is thus entitled to the exemption for sales tax on items purchased for the direct use in the direct production of tangible personal property ("TPP"). During the audit, the Department determined that Taxpayer's process did not qualify for the exemption. The audit report cites to [45 IAC 2.2-5-8\(k\)](#) in part:

"Direct production, manufacture...[sic] of [TPP]" is performance as a business of an integrated series of operations which places [TPP] 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. . . .

Taxpayer argues that it "manufactures" rebar to customer specifications. Taxpayer purchases straight rebar and cuts and/or bends the rebar in multiple ways. Taxpayer argues that it is a manufacturer and is therefore entitled to have purchased the items at issue exempt from sales tax.

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).

The audit report stated that the rebar does not go through a "substantial change" and thus does not qualify as an industrial production process. Thus, to determine whether Taxpayer's process qualifies for exemption, Taxpayer must prove that the rebar goes through a substantial change and creates a new marketable product when it is bent or cut. The Department turns 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 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 *Mechanics Laundry & Supply, Inc. v. Indiana Dep't of State Revenue*, 650 N.E.2d 1223 (Ind. Tax Ct. 1995), the

taxpayer, who operated a commercial laundry, claimed it was entitled to the statutory exemptions under IC § 6-2.5-5 for sales/use taxes concerning cleaning supplies, water, gas, electricity, and other products consumed during the laundering of soiled textiles. Id. at 1226-27. Referring to the statutory and regulatory requirements, the Tax Court stated that the taxpayer failed to demonstrate that its "end product" was "substantially different from the component materials used." Id. at 1229. The Tax Court found that the taxpayer did not "place tangible personal property in a form, composition, or character substantially different from that in which it was acquired." Id. The Tax Court thus concluded that the laundering of soiled textiles did not constitute "production," and, therefore, the taxpayer was not engaged "in an overall process directed to the production of textiles;" rather, the taxpayer was "perpetuat[ing] textiles that were produced by others." Id. at 1229-30. The Tax Court thus determined that the taxpayer was not entitled to the statutory exemptions outlined in IC § 6-2.5-5. Id. at 1233.

In this instance, Taxpayer purchases raw material straight rebar and cuts and/or bends rebar to fit customers' orders. Taxpayer's sole business purpose is cutting and/or bending rebar. While the audit report did correctly state that rebar is still rebar after it is cut and/or bent, the Department was incorrect in determining that the straight rebar does not undergo a substantial change as described in [45 IAC 2.2-5-8\(k\)](#). During the protest process, Taxpayer was able to provide evidence that it is a fabricator of rebar and is entitled to the manufacturing exemption. Its process and end product go through more than the usual bending and shaping of the rebar; the process to develop the rebar was complicated. As in North Cent. Industries, Inc, Taxpayer in this case created a new marketable product. It is able to take an unusable item, straight rebar, and turn it into a new marketable item for its customers.

Next the Department turns to IC § 6-2.5-5-3(b) to determine whether Taxpayer's rebar 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).**

In addition, IC § 6-2.5-5-5.1(b), in relevant part, 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).**

[45 IAC 2.2-5-8\(a\)](#) states that "[i]n general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable." However, [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\(c\)](#).

An exemption applies to "manufacturing machinery, tools, and equipment to be directly used by the purchaser in direct production." [45 IAC 2.2-5-8\(b\)](#). 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\(g\)](#) 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).

Thus, Taxpayer must show that its protested items are directly involved in the direct production of TPP, and that the items have an immediate effect on the products. As stated above the fabrication of rebar, as described by Taxpayer, constitutes a "substantial change" described in [45 IAC 2.2-6-8\(k\)](#). Thus, Taxpayer met its burden showing it is engaging in manufacturing and is therefore entitled to the manufacturing exemption under IC § 6-2.5-5-3(b) for qualified items.

During the hearing, Taxpayer specifically explained why certain specific items are exempt. Taxpayer has however conceded to five items in the audit report that are not exempt; these items include two signs, a poster, gloves, and a time recorder.

The Department refers to the regulations to determine what items are exempt under IC § 6-2.5-5-3(b) and [45 IAC 2.2-5-8](#). While it has been determined that Taxpayer qualifies for the industrial production exemption provided by IC § 6-2.5-5-3(b), not all TPP used by manufacturers qualify for that exemption. TPP may be used in pre or post production and therefore do not qualify for the exemption. The Department imposed use tax on several items on the basis that the manufacturing exemption did not apply. Those items will be discussed below.

Spotter tractor

First mentioned by Taxpayer was a spotter tractor. This tractor is used to pull semis from a parking lot to the loading area and vice versa. Taxpayer puts the finished product on the trailer ready to be shipped to the customer.

[45 IAC 2.2-5-8\(c\)](#), Example (1), states "Equipment used to remove raw materials from storage prior to introduction into the production process or to move finished products from the last step of production" is not exempt because the use of the equipment lacks "an essential and integral relationship with the integrated production system." [45 IAC 2.2-5-8\(c\)](#), Example (4)(G). Thus in this instance, a tractor spotter moving trailers is used in post production and thus is not directly involved in the direct production. For these reasons the spotter tractor is not exempt under IC § 6-2.5-5-3(b).

Application Software

Next is the application software. Taxpayer argues that the software should be exempt because it is used to create measurements and shapes of how the rebar should be bent or cut. The software does not control the cutting or bending machines it merely provides a preproduction blueprint for the finished product. [45 IAC 2.2-5-8\(g\)](#) provides the computer software and hardware are exempt from the use tax to the extent they are used to perform the exempt functions and are taxable to the extent they are used to perform taxable functions. As a computer aided design software it is one step removed from the production process. Thus, the software is not exempt under IC § 6-2.5-5-3(b) and [45 IAC 2.2-5-8\(g\)](#) and is taxable.

Coolant

The final item discussed was ultra plus coolant. Taxpayer explained this item is a lubricant for the rebar machine to prevent wear and tear. Machinery, tools, and equipment predominantly used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax. [45 IAC 2.2-5-8\(h\)\(1\)](#). The coolant however can be used for nonexempt machinery. Taxpayer did not provide information as to whether the coolant is used for exempt machinery or nonexempt machinery. Taxpayer did not meet its burden under IC § 6-8.1-5-1(c). Thus, Taxpayer's protest on the coolant is denied.

FINDING

Taxpayer's protest is sustained subject to a supplemental audit, but denied for the three items specifically, listed: Spotter Trailer, Application Software, Coolant, as well as the items in which Taxpayer conceded were taxable.

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