

**Letter of Findings: 04-20150513
Gross Retail Tax
For the Years 2012 and 2013**

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HOLDING

Indiana Company in the business of manufacturing premium soils and landscape products was entitled to an exemption from sales tax on equipment directly used within its integrated manufacturing process; Indiana Company was not entitled to an exemption on the purchase of packaging equipment utilized after the production of its products.

ISSUES

I. Gross Retail and Use Tax - Equipment Directly Used in Direct Production.

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 § 6-2.5-5-2(a); 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); Conklin v. Town of Cambridge City, 58 Ind. 130 (1877); 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); Rhoads 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\(c\)](#); [45 IAC 2.2-5-8\(d\)](#); [45 IAC 2.2-5-8\(g\)](#); [45 IAC 2.2-5-8\(k\)](#); [45 IAC 2.2-5-9\(c\)](#).

Taxpayer argues that certain equipment it purchased is exempt from sales tax because the equipment is directly used in the direct production of its soil and landscaping products.

II. Gross Retail Tax - Packaging Equipment.

Authority: IC § 6-8.1-5-1(c); [45 IAC 2.2-5-8\(c\)](#); [45 IAC 2.2-5-8\(k\)](#).

Taxpayer maintains that its purchase of packaging and wrapping equipment is exempt from sales and use tax.

III. Gross Retail Tax - Sales of Soil and Landscape Materials.

Authority: IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-2.5-8-8(a); IC § 6-2.5-8-8(b); IC § 6-2.5-9-3; IC § 6-8.1-5-1(c).

Taxpayer states that it should not be required to charge its customers sales tax because doing so would cause tax "pyramiding" and discourage industrial growth in Indiana.

STATEMENT OF FACTS

Taxpayer is an Indiana company in the business of producing and distributing "premium" soils and various landscape materials. Taxpayer produces and sells top soil, peat moss, mushroom compost, composted manure, potting soil, garden soil, peat moss, playground sand, limestone paver base, mulch, and various rock products.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records

and tax returns. The Department's audit concluded that Taxpayer was entitled to an exemption on the purchase of certain equipment used in preparing its potting soil.

However, the audit found that Taxpayer had failed to collect sales tax on materials not being sold to wholesale customers.

The audit also found that Taxpayer had purchased equipment, parts, and supplies without paying sales tax or subsequently self-assessing use tax and that these items were not exempt.

Taxpayer disagreed with the results of the audit 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 and Use Tax - Equipment Directly Used in Direct Production.

DISCUSSION

As a threshold issue, it is the Taxpayer's responsibility to establish that any 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, fn. 9 (Ind. Tax Ct. 2012). 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 investigation, 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 functionally equivalent to the sales tax. See *Rhoads*, 774 N.E.2d at 1047.

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 § 6-2.5-5-2(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).

Taxpayer is in the business of producing and selling "premium soils," landscape materials, and the like. 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 Taxpayer's soil and landscape materials - are taxable. [45 IAC 2.2-5-8\(a\)](#).

However, as authority for its conclusion that certain of its equipment is exempt, Taxpayer cites to the Indiana statute, 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 that particular property that 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\(g\)](#).

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 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.

Proper application of this particular exemption requires determining at what point "production" begins and at what point "production" ends because equipment and supplies used before or after production is not entitled to the exemption. [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.

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

In addition, Taxpayer has the burden of establishing that it is entitled to the sought after exemption. 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).

The issue is whether the specific items of Taxpayer's equipment, supplies, or materials are exempt because these items are directly used in the production process and because they have an immediate effect on the article being produced. [45 IAC 2.2-5-8\(c\)](#).

Taxpayer begins its production 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. 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 has additional plant nutrients added or is immediately bagged. 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, it is clear that the Peat is sold to its customers in a manner different from which it was acquired by Taxpayer. Taxpayer has provided sufficient documentation to demonstrate that it turns a nonmarketable product into a scarce marketable economic good. Since it has been determined that the Peat undergoes a substantial change pursuant to [45 IAC 2.2-5-8\(k\)](#), the next step is to determine Taxpayer's integrated process.

Taxpayer's process begins with the process of excavation. The excavation process includes draining the bog before any Peat is removed. 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

Subject to review by the Department's Audit Division, Taxpayer's protest is sustained.

II. Gross Retail Tax - Packaging Equipment.

DISCUSSION

Taxpayer argues that equipment used to package Taxpayer's product is not subject to sales or use tax because the equipment is "required to place the product into its completed form" and part of an "integrated production process that turns a pile of soil, sand, or rock product and a roll of plastic into a pallet of bagged product."

As noted in Part I above, Taxpayer has the burden under IC § 6-8.1-5-1(c) of establishing that the proposed assessment is wrong.

Taxpayer has failed to explain what equipment is at issue, how this equipment has a direct effect on Taxpayer's product, or how the equipment causes a substantial change in that product. One of the touchstones of the manufacturing exemption is that the equipment at issue must have "an immediate effect on the article being produced." [45 IAC 2.2-5-8\(c\)](#). Another basic prerequisite is that the equipment leads to a "substantial change" in the article being produced. [45 IAC 2.2-5-8\(k\)](#). In this case, the Department is unable to agree that Taxpayer has established that equipment used for "bagging and palletizing" is exempt from tax.

FINDING

Taxpayer's protest is respectfully denied.

III. Gross Retail Tax - Sales of Soil and Landscape Materials.

DISCUSSION

Taxpayer argues that it should not be required to charge sales tax to its customers because doing so would result in tax pyramiding, "discourage industrial growth, [] reduce competition in Indiana, [and] ultimately harm[] Indiana citizens."

The audit found that it had been selling bulk products to certain businesses which were not entitled to the

"purchase-for-resale" exemption. Taxpayer was provided with copies of a form AD-70 and was required to verify that its past customers were entitled to purchase the products exempt. According to the audit report, "Taxpayer stated it would most likely not make attempts to secure executed AD-70[s] from its customers as the amount of sales and subsequent sales tax liability was not significant enough for the effort required to obtain the certificates."

As a result, the audit assessed tax on sales for which no exemption was readily apparent from the face of the sales document. Taxpayer now objects because - according to Taxpayer - charging tax on the sale of its products would lead to tax pyramiding and discourage commercial growth in Indiana.

IC § 6-2.5-2-1(a) imposes "[a]n excise tax, known as the state gross retail tax . . . on transactions made in Indiana." Under IC § 6-2.5-2-1(b), the retail merchant is required to "collect the tax as agent for the state." The retail merchant "holds those taxes in trust for the state and is personally liable for the payment of those taxes" IC § 6-2.5-9-3.

Under certain circumstances, the retail merchant is not required to collect sales tax. For example, under IC § 6-2.5-8-8(a), "A person . . . who makes a purchase in a transaction which is exempt from the state gross retail and use taxes, may issue an exemption certificate to the seller instead of paying the tax."

IC § 6-2.5-5-8(b) provides an exemption for transactions in which tangible personal property is purchased with the intent of reselling that property:

Transactions involving tangible personal property . . . are exempt from state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business without changing the form of the property.

Once the purchaser provides the exemption certificate, the retail merchant is under no obligation to collect sales tax on the transaction. IC § 6-2.5-8-8(a) states that, "A seller accepting a proper exemption certificate under this section has no duty to collect or remit the state gross retail or use tax on that purchase." (Emphasis added).

The law imposes on Taxpayer two obligations. In selling its products, it is required to act as an agent for the state collect and remit sales tax on the retail transactions it enters into with its customers. Alternatively, Taxpayer is required to obtain from those customers a properly completed exemption certificate. In this case, Taxpayer has done neither; Taxpayer explains that requiring it to collect the tax would place it at a competitive disadvantage. The Department acknowledges that relieving Taxpayer of its obligation to collect the tax would provide Taxpayer a "leg-up" over its competitors. However, the law simply does not allow the economic advantage it seeks. The Department believes that requiring Taxpayer to collect the tax from its customers or obtain an exemption certificate creates a level-playing field for all Indiana businesses selling products similar to that of Taxpayer.

Taxpayer has not met its burden under IC § 6-8.1-5-1(c) of establishing that the proposed assessment is wrong.

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

Subject to review by the Department's Audit Division, Taxpayer is entitled to an exemption on equipment directly used in Taxpayer's integrated production process; Taxpayer is not entitled to an exemption on the purchase of equipment to package and ship Taxpayer's products after production of the product ceases; Taxpayer is required to collect sales tax on retail sales of its products.

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