

Letter of Findings: 04-20160308; 04-20160309
Gross Retail and Use Tax
For the Years 2012, 2013, and 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Indiana Manufacturer failed to establish that computer software was directly involved in an integral process by which it manufactured DVDs, CDs, and Blu-ray discs; the Department agreed that Indiana Manufacturer was entitled to an exemption on purchases of HVAC parts because the HVAC equipment had an immediate, demonstrable effect on the production of the discs.

ISSUES

I. Gross Retail Tax - Computer Software.

Authority: IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-2.5-5-3; IC § 6-8.1-5-1(c); 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); [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\(g\)](#).

Taxpayer argues it was not subject to sales or use tax on the purchase of Oracle computer software on the ground that the software is directly used in the production of Taxpayer's DVDs, CDs, and Blu-ray discs.

II. Gross Retail Tax - Bar Code Reader.

Authority: IAC 2.2-5-8(a)-(c); [45 IAC 2.2-5-8\(d\)](#)

Taxpayer states that it was not required to pay sales or use tax on the purchase of bar code readers because the readers are essential to and directly used within the production of Taxpayer's DVDs, CDs, and Blu-ray discs.

III. Gross Retail Tax - Air Handling Equipment.

Authority: Indiana Dep't of Revenue v. Kimball Int'l, Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); [45 IAC 2.2-5-8\(c\)](#); Letter of Findings 04-20050063 (May 22, 2006); Letter of Findings 04-20020168 (May 29, 2003).

Taxpayer maintains it was not required to pay sales or use tax on the purchase of heating, ventilating, and air conditioning ("HVAC") replacement parts on the ground that the maintenance of temperature and humidity standards with its manufacturing facility is essential to the production of its of DVDs, CDs, and Blu-ray discs.

STATEMENT OF FACTS

Taxpayer is an Indiana business which manufactures digital optical storage discs (CDs), digital video discs (DVDs), and "digital optical disc storage" (Blu-ray) discs. Taxpayer acquires audio, video, and computer data from its customers and converts that data into CDs, DVDs, and Blu-ray discs. Taxpayer produces multiple copies of the CDs, DVDs, and Blu-ray discs. Taxpayer also provides custom printing and packaging for these customers.

Taxpayer submitted a refund requesting the return of tax paid on the purchase of computer software. The Indiana Department of Revenue ("Department") granted the refund request.

Subsequently the Department conducted an audit review of Taxpayer's business records and tax returns. The audit determined that the refund should not have been granted. In addition, the audit determined that Taxpayer

owed additional amounts of sales and use tax on the purchase of other items of equipment and supplies.

Taxpayer disagreed with the assessment of tax on the purchase of the computer software along with the unrelated assessments. Taxpayer 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 - Computer Software.

DISCUSSION

Taxpayer purchased Oracle computer software. The issue is whether the purchases of the software were exempt from sales/use tax on the ground that the software is directly used in the manufacture of its CDs, DVDs, and Blu-ray discs.

A. Audit Response.

The Department's audit found that the Oracle software was not exempt from tax because the "software was used primarily for pre-production activities such as scheduling, purchasing, inventory tracking and other administrative activities." The audit report cited to [45 IAC 2.2-5-8\(g\)](#) as authority for its decision. The cited provision states:

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.

The audit reviewed invoices for the purchase of the following software items:

- Oracle Data Base Enterprise Addition and updates;
- Internet application Server Enterprise Edition software and updates;
- Oracle JD Edwards World - Data Management;
- Oracle Data Base Enterprise Addition - Business Intelligence;
- Oracle Human Resource, Recruitment, Performance Management, Learning Management;
- Oracle Software Updates E-Business;
- Supplier Portal; Purchasing User; Asset Manager;
- Warehouse Management.

The audit concluded that the software was used for "administrative purposes" and therefore not entitled to the sought-after manufacturing exemption.

B. Taxpayer's Response.

Taxpayer argues that the software was "used to direct and control its manufacturing process," that the Department entered into a settlement agreement addressing previous purchases of software, that it's "operations have not changed," and that the more recent software purchases "should be accorded similar treatment." Taxpayer concludes that all of the purchased software is essential and necessary to the operation of its manufacturing facility.

Taxpayer has provided an explanation of the thirteen stages involved in the production of Taxpayer's discs. According to Taxpayer, each of these stages is one-step in the integral process by which Taxpayer manufactures and packages these discs.

- Work-in-Process (Automated)
- Conventional Glass Mastering (CD & DVD)
- Phase Transition Mastering (BD & UHD)
- Tooling
- CD Replication (Injection Molding/Sputtering/Coating)
- DVD Replication (Injection Molding/Layer 1 Sputtering/Layer 2 Sputtering/Bonding)

- BD Replication (Injection Molding/L1 Sputtering/L2 Embossing/L2Sputtering/Cover Coating/SIN Layer/Hard Coating)
- CD Printing (Screen Making/Screen Printing)
- DVD Printing (Screen Making/Screen Printing/Plate Making/Offset Printing)
- BD Printing (Plate Making/Offset Printing)
- CD Individual Unit Packaging (Jewel Case Assembly/JC Wrapping/JC Stickers)
- DVD Individual Unit Packaging (Amaray Case Assembly/AC Wrapping / AC Stickers)
- BD Individual Unit Packaging (Amaray Case Assembly/ AC Wrapping / AC Stickers)

Taxpayer concludes that the Oracle software purchases - listed above - are exempt because the software is directly used to perform automated functions which occur within one of the thirteen manufacturing steps listed above.

Based on the distinction of its various manufacturing and non-manufacturing "process steps" and its manufacturing and non-manufacturing "head count," Taxpayer asks for a refund of between 65 and 91 percent of the sales tax paid on the purchases.

C. Hearing Analysis.

It is Taxpayer's obligation here to establish that the audit's conclusion - that the software is used for administrative purposes - 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).

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). However, Indiana law permits specific exemptions from the tax. IC § 6-2.5-5-3, 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 paying 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."

Taxpayer first claims that the software is exempt because it is used in manufacturing pursuant to [45 IAC 2.2-5-8](#). This regulation at subsection (c) provides in relevant part as follows:

(c) 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.

-EXAMPLES-

...

(5) A computer is used to control and monitor various aspects of the plating and surface-treatment operations in Example (1). The computer is located in a separate room in a different part of the plant from the plating and surface-treatment operations but is connected to the equipment comprising those operations by means of electrical devices. The computer equipment, including related terminals, printer, and memory, data storage, and input/output devices, is exempt because its use in this manner is an integral and essential part of the integrated production process.

(6) A computer is used to process accounting, personnel, and sales data. The computer is taxable because its use in this manner is not an integral and essential part of the integrated production process.

(7) A computer is used 40[percent] of the time to perform the functions described in Example (5) and 60[percent] of the time to perform the functions described in Example (6). The taxpayer is entitled to an exemption for the computer equipment, including related equipment such as that described in Example (5), equal to 40[percent] of the gross retail income attributable to the transaction or transactions in which the computer equipment was purchased.

...

(9) A manufacturer of printed circuit boards uses a computerized locator system to assist and direct employees in placing components in their correct positions on printed circuit boards. The system visually demonstrates the location on the board requiring a component and at the same time dispenses the appropriate component for insertion by the employee. The locator system is an essential and integral part of the integrated production process and is, therefore, exempt.

[45 IAC 2.2-5-8\(g\)](#) goes on to state in relevant part that:

"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.

-EXAMPLES-

...

(6) Computers which are interconnected with and control other production machinery or are used to make tapes which control computerized production machinery are exempt from tax.

(7) Computers which produce designs which are not sold as products are not exempt. Thus, computer-aided design is a nonexempt function.

(8) A computer is used 40[percent] of the time for the purpose described in Example (6) and 60[percent] of the time for the purpose described in Example (7). The taxpayer is entitled to an exemption equal to 40[percent] of the gross retail income attributable to the transaction in which the computer was purchased.

Taxpayer has not specifically explained how or to what degree any of the Oracle software is used in manufacturing CDs, DVDs, and Blu-ray discs. There is nothing on the face of the software descriptions which clearly establishes that any of the software is directly used to guide, control, monitor, or directly affect the discs or the packaging of the discs. To the contrary, at least one of the packages - Oracle Human Resource, Recruitment, Performance Management - seems entirely unrelated to any manufacturing function. A cursory review of publicly available information indicates that the "Oracle JD Edwards World - Data Management" software is used in "sharing information, boosting performance, trimming costs, and driving profitable growth" all of which are admirable aims but unlikely to have an "immediate effect on the article being produced." [45 IAC 2.2-5-8\(g\)](#).

The Department agrees that the Taxpayer engages in activities which constitute manufacturing and that the software was not purchased for frivolous purposes; it is entirely likely that the software is necessary to the smooth and successful operation of its business. However, as [45 IAC 2.2-5-8\(g\)](#) states:

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.

The Department does not agree that Taxpayer has met its burden under IC § 6-8.1-5-1(c) of establishing that the audit was "wrong" when it concluded that the Oracle software "was primarily [used] for pre-production activities such as scheduling, purchasing, inventory tracking and other administrative activities." Even if Taxpayer were to establish with any certainty that any portion of the software is used in manufacturing, there is no basis on which to calculate the amount of refund to which Taxpayer would be entitled.

FINDING

Taxpayer's protest is respectfully denied.

II. Gross Retail Tax - Bar Code Reader.

DISCUSSION

Taxpayer purchased "SPA 12001 BCR Reader[s]" purportedly used in its "Special Packaging Area (SPA) Wrap Lines." Taxpayer offers an explanation of how these devices are used.

These bar code readers scan the bar code that is etched into each individual disc to ensure that there is no accidental mixing of incorrect discs in any given Special Packaging Area disc run.

Taxpayer maintains that the bar code reader is "essential and directly used in [its] SPA line manufacturing for individual units."

Taxpayer concludes that the bar code reader is exempt because the equipment is directly used in the "direct production" of CDs, DVDs, and Blu-ray discs purchased by retail consumers. Taxpayer relies on [45 IAC 2.2-5-8\(d\)](#) which 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.

(Emphasis added).

Taxpayer explains that it is not simply in the business of manufacturing CDs, DVDs, and Blu-ray discs themselves but it is in the business of selling a wrapped and labeled jewel or Amaray case which contains the correct disc. ("Amaray" is the brand name of a plastic disc cover with a hinged, internal spine and clear external sleeve.) The bar code reader scans each disc assuring that the right disc is packaged in the right case and assuring that the consumer acquires the disc labeled and advertised on the package. Essentially, the bar code reader "marries" the right disc with the right disc package.

In this particular case, the Department is prepared to agree that Taxpayer has met its burden of establishing that the bar code readers are "directly used by [Taxpayer] in direct production" and has an "immediate effect on the article being produced." [45 IAC 2.2-5-8\(a\)-\(c\)](#). The bar code readers are exempt because they function within the manufacturing process which produces consumer CDs, DVDs, and Blu-ray discs in their "completed form" [45 IAC 2.2-5-8\(d\)](#).

FINDING

Taxpayer's protest is sustained.

III. Gross Retail Tax - Air Handling Equipment.

DISCUSSION

Taxpayer purchased belts, bearings, and other parts used in its air handling ("HVAC") equipment. Taxpayer maintains that the HVAC parts are exempt. Taxpayer explains that the HVAC equipment is necessary "to manage temperature, humidity and cleanliness" in its CD, DVD, and Blu-ray manufacturing facility. Taxpayer admits that its facility encompasses both manufacturing and non-manufacturing areas and that it is unable to accurately determine whether any particular HVAC part is used in the manufacturing area of its plant or whether a part is used in a non-manufacturing area of the plant. Therefore, Taxpayer argues that:

The most accurate way to access the amount of parts (and associated costs) used for production equipment was to calculate the square footage of each [air handling unit] in terms of the boundaries of the zone it covered.

Based on Taxpayer's calculation, 53.3 percent of its facility is used in the manufacture of its CDs, DVDs, and Blu-ray discs.

Taxpayer relies on [45 IAC 2.2-5-8\(c\)](#) as authority for its position that the replacement HVAC parts are exempt. The regulation states as follows:

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.

Indiana case law on this exemption issue is instructive. In *Indiana Dep't of Revenue v. Kimball Int'l, Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988), the taxpayer claimed it qualified for the manufacturing exemption for paint spray booths, air "make up" units (including component parts) located in the taxpayer's finishing rooms ("paint booths"), which were used to finish wood products such as pianos and furniture. The court held that a taxpayer's equipment "will be held exempt if it is an essential and integral part of an integrated process that produces tangible personal property." *Id.* at 457. The paint booths came "into play during the final phase of the manufacturing process, when the finish is applied" and were "isolated from the rest of each plant." *Id.* at 455. The spray booths created an airflow that promoted drying of newly applied finish. This process guarded against paint blistering and controlled paint flaws in newly applied finish. By recycling air at a rate of 120,000 ft³ per minute, the paint booths also removed excess harmful chemicals that were byproducts of the process. Moreover, without the temperature and humidity controls the finish would become cloudy and the product unmarketable. The paint booths were therefore found to be integral and essential to the manufacturing process. The court granted Kimball the manufacturing exemption for the natural gas used in the paint booths. *Id.* at 457.

Manufacturing exemption cases are decided under the totality of the circumstances, making each case unique. Nonetheless, Kimball and the Department's long-standing Letters of Findings which have addressed this particular issue suggest two elements necessary to qualify for the exemption. First, the ventilation or air conditioning must play an active and integral role in the manufacturing process; but for the use of a taxpayer's HVAC equipment, the manufacturing process would be impossible and a final marketable product would not be produced. See Letter of Findings 04-20050063 (May 22, 2006), 20060802 Ind. Reg. 045060252NRA; Letter of Findings 04-20020168 (May 29, 2003), 26 Ind. Reg. 3778. While using HVAC equipment can be an element of the manufacturing process, merely managing or conditioning the air environment of an entire plant, by itself, is not manufacturing. Second, normally only demarcated areas in which there is active manufacturing that depends on a controlled environment are entitled to the exemption. For example, paint booths or finishing stalls within a plant are such areas. The mere fact that the manufacturing occurs within an open area of a plant does not mean the HVAC equipment is exempt, unless the size and volume of the manufactured product is so large as to dwarf the plant and render the whole interior an integral part of the processing facility.

Taxpayer explains why it believes its HVAC equipment - and the parts here at issue - are an "integral part of an integrated process which produces tangible personal property." [45 IAC 2.2-5-8\(c\)](#).

Taxpayer explains that within the manufacturing, "replication," and printing portion of its facility, the temperature must be maintained at between 70 to 72 degrees. Within those production areas, the "air is changed 10 times per hour" and must be maintained at a "positive pressure." Taxpayer explains that its manufacturing process generates "a tremendous amount of heat" requiring an active air exchange process during "all four seasons experienced in Indiana."

Taxpayer further explains that the manufactured discs require application of a "finish lacquer" coating that is "dispensed and spun out to create a uniform layer of a specific [micron] thickness." According to Taxpayer, if the "viscosity of the lacquer is thicker than expected because the temperature is too cold . . . the lacquer thickness is too thick." Conversely, "if the room is too hot, the lacquer is too thin and the layer will be too thin." If the lacquer thickness is incorrect, the disk will be rejected during the quality assurance process.

Taxpayer points out that the HVAC equipment is necessary to regulate the humidity level within its facility. If the humidity level is too low, "static can occur" which may cause dust particles to adhere to the discs or cause the stacked discs to adhere to each other. Taxpayer explains:

If there is static, the discs stick to each other and it becomes more challenging for the loading robotics to remove one disc at a time during loading of the next operation. The result could be damaged discs, machines will crash, or at least [experience] machine downtime.

In addition, Taxpayer explains that static discharges "can occur at the embossing station of a dual layer 'Blu-ray'

machine." In these instances, the "master" recording will be ruined causing production delays while a duplicate master is located and substituted.

Although Taxpayer's production facility apparently lacks sharply "demarcated areas" of production suggested in the authorities, there is sufficient evidence to conclude that the size and volume of the facility's interior allow for Taxpayer's HVAC equipment to fall within the ambit of [45 IAC 2.2-5-8\(c\)](#) as an essential and integral part of the process by which Taxpayer manufactures CDs, DVDs, and Blu-ray discs.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer failed to establish that the purchase of the Oracle software is exempt from sales and use tax. In all other respects, Taxpayer's protest is sustained.

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