DEPARTMENT OF STATE REVENUE

04-20160313.LOF

Letter of Findings: 04-20160313
Gross Retail and Use Tax
For the Years 2012 and 2013

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Petroleum Company was not required to pay sales tax on materials and equipment deployed at Petroleum Company's light product distribution terminals; the equipment was directly used in the production of Petroleum Company's products and the distribution terminals produced a product substantially different from the petroleum products and additives initially delivered to the facility.

ISSUE

I. Gross Retail and Use Tax - Exempt Manufacturing Equipment.

Authority: 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 § 6-2.5-3-4(a)(2); IC § 6-2.5-5-3; IC § 6-2.5-5-3(b); IC § 6-8.1-5-1(c); Brandenburg Industrial Services Company v. Indiana Department of Revenue, No. 49T10-1206-TA-00037, 2016 WL 4239921 (Ind. Tax Ct. 2016); 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); Rhoade v. Indiana Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); 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 2.2-5-10(k).

Taxpayer argues that it was not required to pay sales tax when it purchased equipment and materials consumed or installed at one of Taxpayer's Indiana petroleum distribution terminals.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of producing, marketing, and distributing petroleum products. Taxpayer operates distribution terminals in Indiana.

The Indiana Department of Revenue ("Department") conducted a sales and use tax audit review of Taxpayer's purchase records, sales records, work papers, and tax returns. The audit resulted in an assessment of additional sales and use tax.

Taxpayer disagreed with the assessment 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 - Exempt Manufacturing Equipment.

DISCUSSION

The issue is whether equipment and materials purchased, installed, and employed at one of Taxpayer's distribution terminals are exempt from Indiana's sales/use tax on the ground that these items are directly involved in manufacturing a product substantially different from the raw materials originally delivered to the terminals.

A. Audit Findings.

The Department's audit found that Taxpayer purchased and installed equipment and materials which were used, installed, or employed at one of Taxpayer's Indiana "light product terminals." The audit disagreed with Taxpayer's contention "that the blending of fuels at the light product terminals qualif[ies] for exemptions in accordance with IC § 6-2.5-5-3 . . . ." In part, the cited statute provides a specific sales tax exemption as follows:

> [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, manufacturing, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

IC § 6-2.5-5-3(b).

In support of its decision, the audit also cited as authority 45 IAC 2.2-5-10(k) which provides as follows:

> Processing or refining is defined as the performance by a business of an integrated 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. Operations such as distilling, brewing, pasteurizing, electroplating, galvanizing, anodizing, impregnating, cooking, heat treating, and slaughtering of animals for meal or meal products are illustrative of the types of operations which constitute processing or refining, although any operation which has such a result may be processing or refining. A processed or refined end product, however, must be substantially different from the component materials used.

(Emphasis added).

The audit found that the "blending" of various components at the Taxpayer's "light product terminals" did not qualify for the exemption because the "light product" delivered to Taxpayer's customers was not "substantially different from the component materials used." As explained in the audit report:

> The [T]axpayer's blending of liquid fuel components is not producing a final product which is substantially different from the components used. Blended diesel is still essentially "diesel fuel." The blending of ethanol with gasoline produces a product which is still recognizably and functionally gasoline.

B. Taxpayer's Response.

Taxpayer argues that the process which is undertaken at its distribution terminals constitutes "manufacturing." Taxpayer explains that it owns petroleum refineries which "transform crude oil and feedstock products into petroleum components." Taxpayer explains that it delivers these components to a network of light product terminals located outside Indiana and inside Indiana. The components are delivered to each terminal by pipeline, by truck, or by marine vessel. Taxpayer explains that, at these Indiana terminals;

> [T]he components undergo a blending process [which is] the final process in the manufacture of petroleum products, to create finished marketable petroleum products. In order to accomplish the blending process, the terminals consist of:
>
> • Component storage tanks where unfinished components and additives are stored in separate tanks or supplies;
> • Valves which control the component and additive movements;
> • Piping to transport the components and additives throughout the blending process from the storage tanks to the load rack;
> • Load rack where customer/jobber trucks receive finished, marketable products; and
> • Computer systems and preset consoles which control the blending specification requirements per regulatory requirements and the customer's request.

Taxpayer receives, processes, and stores at each terminal six "main unfinished components and various additives . . . ." From these six components, Taxpayer's customer may specify and purchase more than "25 recipes of finished product . . . ." Taxpayer explains that "[e]ach recipe consists of unique properties and characteristics pursuant to the customer's demands." The 25 recipes may call for blending varying grades of gasoline and other petroleum distillates such as diesel fuel, ethanol, butane, various chemical additives, and - in certain instances - "indelible diesel dye markers."

Taxpayer explains that, for example, gasoline delivered during winter months requires these "distillates [] be blended with additives or blended with [kerosene] and . . . diesel components." Doing so "ensures that the [final] product has the proper cold weather flow characteristics so that it does not clog fuel lines due to formation of wax crystals." As another step in insuring that the delivered product will function as required during winter months, butane is injected into the fuel by a process "which continually monitors volatility parameters . . . to ensure [that] volatility specifications of the finished blend are maintained."

Taxpayer delivers these finished products to independent "jobbers" who are responsible for accepting delivery at each terminal location and then transporting the product by truck to third-party gasoline and diesel retailers.

The product is delivered to the jobbers at each of the terminal's "load rack." (As used in the petroleum distribution business, a "load rack" is a loading and unloading platform.) The jobber first enters product specifications into Taxpayer's online "Terminal Automation System" (TAS) computer program. According to Taxpayer, the TAS "contains the 'recipe' for each of the saleable products," "contains the proper proportions of each component," and "controls the blending of components into the [jobber's] transport trucks . . . ." During delivery, the TAS is monitored both remotely and locally by the individual terminal's onsite personnel.

During delivery of the blended product to the jobber's truck, Taxpayer's TAS delivery systems employs a "vapor recovery process" which captures vapors generated during delivery, filters the vapors, absorbs hydrocarbons, and recycles any liquid hydrocarbons into a "separator vessel." The recaptured hydrocarbon liquids are returned to one of Taxpayer's refineries.

The TAS monitors the delivered product's based on the system's specifications and tolerances.

> If any [truck] compartment is found to be out of tolerance or off specification during the loading process, the TAS system overfill protection will immediately shut down the blending process and alert the driver and terminal personnel.

If the product is found to be out-of-specification or outside the product's allowable tolerances, the TAS will interrupt the loading of the truck storage compartment and withhold issuance of the bill of lading. The withheld bill of lading "requires intervention by terminal personnel to either correct the final product or pump the off-specification blended components out of the [truck compartment]." Off-specification product is recycled into a recovery tank waiting secondary refinery of that product. The off-specification product is rerouted back to the refinery for secondary reprocessing.

During delivery, the TAS monitors, controls, and regulates the temperature of the constituent products because an unmonitored blending process may "cause a small volumetric increase over the sum of the volume of the two components."

Taxpayer explains that, during delivery, a variety of additives are added to the product "to enhance fuel quality and performance and to maintain fuel standards," to meet customer requirements, and to "meet EPA and other industry requirements." For example, "conductivity additives" are injected into the product to maintain "ASTM" (American Society for Testing and Material) standards for the products' "lubricity and conductivity properties." These conductivity standards are imposed to assure "dissipat[ion] of static electricity [and] eliminate potentially hazardous environments which . . . promote static build-up."

Taxpayer maintains that the point at which the finished product is delivered to the jobber constitutes the "point of sale of [the] marketable product." According to Taxpayer the combination of the constituent products and the process by which those products are delivered "create[s] a new manufactured product that cannot be separated or returned to the original state." Therefore, Taxpayer maintains that the purchase of materials and equipment purchased and employed within Taxpayer's light product materials is exempt from sales tax.

C. Hearing Analysis.

As a threshold issue, it is the Taxpayer's responsibility to establish that the assessment of sale and use tax 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). A taxable "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 . . . ." Rhoade v. Indiana Dep't of State Revenue, 774 N.E.2d 1044, 2047 (Ind. Tax Ct. 2002).

Taxpayer is in the business of selling and delivering to its jobber/customers, a variety of petroleum products. Taxpayer does so in part by means of equipment located and employed at one of Taxpayer's Indiana light product terminals. 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 petroleum products - are taxable unless specifically exempted under the applicable law. 45 IAC 2.2-5-8(a). Any exemptions which apply to sales tax are also applicable to use tax. IC § 6-2.5-3-4(a)(2).

However, as authority for its conclusion that certain of its terminal equipment is exempt, Taxpayer cites to the Indiana statute, IC § 6-2.5-5-3, which provides an exception to this "general rule." The statute provides 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."

The regulation further explains 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 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.

(Emphasis added).

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.

Since Taxpayer argues it is entitled to an exemption from the general applicability of the sales and use tax, 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 also 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 equipment deployed at Taxpayer's terminals is exempt because these items are directly used within the production process, because the equipment has an immediate effect on the article being produced, and because the product delivered to its customer/jobbers is substantially different from the variety of distillates and additives initially delivered to the terminals. 45 IAC 2.2-5-8(c).

D. Conclusion.

The question is whether the product Taxpayer delivers at it distribution terminals has undergone a "substantial change" into a product which has a "distinctive name, character, and use" as required by 45 IAC 2.2-5-10(k). With the exception of kerosene - which is delivered to the jobbers in the same form as received from the refineries - the remaining distillates cannot be sold without being modified in a process which occurs within the four corners of the terminals. As delivered, these distillates and additives are not acceptable to Taxpayer's jobber/customers because these products do not meet performance, safety, or EPA standards. As detailed in Section B above, these raw materials undergo a complex, exacting, and - for all practical purposes - chemically irreversible transformation into one of the 25 products required by the upstream retailers.

The Department takes note of the Indiana Tax Court's decision in Brandenburg Industrial Services Company v. Indiana Department of Revenue, No. 49T10-1206-TA-00037, 2016 WL 4239921 (Ind. Tax Ct. 2016), granting partial summary judgment in favor of a scrap metal dealer and demolition company. In that decision, the court found that the petitioner was entitled to an exemption on equipment used to remove scrap metal from demolished buildings. Id. at *7. The court did so because it reasoned that locating, removing, and cutting scrap metal constituted an "integrated series of operations" which lead to a "substantial change or transformation" in the scrap metal. Id. at *4. The court reasoned that the act of extracting and cutting the materials transformed the salvaged metal into a "form, composition, or character different from that in which it was acquired." Id. Given the benchmark set out in the Brandenburg decision, it is clear the court regards almost any marginal alteration in the structure or even the location of materials as constituting a "substantial change or transformation."

Even given the Kimball "strictly construed standard," and especially given the expansive reasoning of the Tax Court's Brandenburg decision, Taxpayer has met its burden under IC § 6-8.1-5-1(c) of establishing that the original assessment was "wrong" and that, with the exceptions noted above, the terminal equipment is exempt from the tax.

However, the Department does not agree that the kerosene handling equipment meets the exemption's requirement. In addition, the Department does not agree that the "load rack" equipment is exempt because this

equipment constitutes "post-production" equipment as specified in 45 IAC 2.2-5-8(d).

The Department's Audit Division is requested to review the listing of equipment and materials provided by Taxpayer during the administrative hearing and make adjustments to the assessment consistent with this Letter of Findings.

FINDING

Taxpayer's protest is denied in part and sustained in part.

Posted: 11/30/2016 by Legislative Services Agency
An html version of this document.