

Letter of Findings: 04-20160350
Gross Retail Tax
For the Years 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 Company - in the business of slitting and cutting steel coils owned by Indiana Company or its customers - qualified as a "manufacturer" and/or "industrial processor" because the steel coils underwent a "substantial change;" Indiana Company was entitled to claim an exemption on items of equipment and supplies directly involved in its manufacturing process.

ISSUES

I. Gross Retail Tax - Industrial Processor / Manufacturer.

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); *Rhoades 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](#); [45 IAC 2.2-5-10\(k\)](#).

Taxpayer argues that the Department erred in concluding that it functioned neither as a "manufacturer" nor as an "industrial processor" and that it was therefore not entitled to claim tax exemptions on equipment and materials it had purchased for use at its facility.

II. Gross Retail Tax - Exempt Equipment.

Authority: IC § 6-2.5-5-3(b); IC § 6-2.5-5-9(d); IC § 6-8.1-5-1(c); [45 IAC 2.2-5-8\(d\)](#); [45 IAC 2.2-5-8\(g\)](#).

Taxpayer maintains that equipment used to cut and slit steel coils is exempt because the equipment has a direct effect on its coils and its customers' coils.

STATEMENT OF FACTS

Taxpayer is an Indiana company in the business of - according to public information -providing its customers "the highest quality, scratch free, toll slitting of aluminum coils and bare, plastic laminated and coated steel coils."

Taxpayer buys metal coils from steel mills. Taxpayer purchases coils of "light gauge steel, tin, tinplate, stainless steel, cold rolled steel, and galvanized steel."

According to the Indiana Department of Revenue's ("Department") audit report, Taxpayer owns 98 percent of the metal coils it obtains from steel mills. The remaining 2 percent of the steel is dealt with in process called "tolling." In those cases, the customer owns the metal coil with Taxpayer providing the customer with its cutting and slitting services.

Taxpayer's customers include auto manufacturers, metal window fabricators, cable manufacturers, and the like.

The Department's audit report describes Taxpayer's function as follows:

The [Taxpayer] modifies the steel coils in order to ensure that the steel coils will work in the customer's production process. [Taxpayer] readies the steel coils for its customers to suit the various specifications of its customers, which ultimately involves slitting the steel coils. In order to ready the steel coils, [Taxpayer] has become an expert in the raw material needs of its customers. For each customer, numerous specifications and tolerance levels have to be met.

For each customer, the [Taxpayer] has to provide the proper steel coil that will, at a minimum meet hardness specifications. Additionally, the customer's specifications may involve a coating application to the slit coil. However, [Taxpayer] does not itself apply any coatings; instead this is contracted out to another processor.

The primary aspect of the [Taxpayer's] business is to slit steel coils to customer's specifications. This is achieved through the [T]axpayer's three coil slitter lines and one cut-to-length line located at its [] Indiana facility.

After a steel coil has been slit [and cut to length], it is rewound. Other than the specialty slitter, this is achieved through a conveyor including a twenty foot pit that allows the slit coils to hang thereby allowing gravity to pull the slack out of the coil as it is rewound. Loose coils will be returned by its customers. Once the slit coil is rewound, each slit coil is packaged according to customer specifications. Packaging requirements differ among its customers. At a minimum, the slit coils are placed on their side with spacers placed between each slit coil and then the entire slit coil is placed on a pallet and wrapped.

The Department conducted an audit review of Taxpayer's business records and tax returns. The audit noted that the Department had previously "classified [Taxpayer] as a manufacturer with regard to the steel coils it owned and modified for resale." In addition, the audit noted that the Department had previously "classified [Taxpayer] as an industrial processor with regard to its tolling sales."

However, the Department's audit concluded that, with respect to coils slit to customer specifications, Taxpayer was neither a "manufacturer" nor an "industrial processor."

As a result, the Department concluded that Taxpayer erroneously claimed sales and use tax exemptions on equipment used in providing customers steel coils prepared to the customers' specifications. The audit's determination resulted in an assessment of additional sales and use tax. Taxpayer disagreed with the audit's conclusion and submitted a protest to that effect. An administrative hearing was conducted by telephone during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Gross Retail Tax - Industrial Processor / Manufacturer.

DISCUSSION

The issue is whether Taxpayer qualifies either as a "manufacturer" and/or an "industrial processor" when it cuts and slits steel coils.

A. Audit Results.

The Department's audit determined that Taxpayer's activities did not qualify as "manufacturing" nor did they qualify as "industrial processing." In arriving at that conclusion, the audit report cites to [45 IAC 2.2-5-8\(k\)](#) which provides as follows:

"Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance as 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, 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).

The audit found that Taxpayer's (or its customers') steel coils did not undergo a "substantial change." As explained in the report, "For the case at hand, although the steels coils are cut to specific widths or lengths, the end result is still steel coils." As a result, the audit found that Taxpayer was "neither a manufacturer nor an industrial processor."

B. Taxpayer's Response.

Taxpayer disagrees stating that it "buys steels in coil form from the mills and further processes and treats the metal, slit[s] the metal to size and further customize[s] the order by providing further industrial processes to ready the metal for its use by the eventual metal stamper in completing the product."

Taxpayer included copies of its SIC ("standard industrial code") classification and NAICS ("North American Industry Classification System") code as supporting its argument that it is - and has been - properly and commonly classified as both a manufacturer and industrial processor.

In addition, Taxpayer states that it relied on "prospective treatment" for the years at issue. "On all of our prior audits we have been properly treated as a manufacturer and industrial processor by the State of Indiana and allowed the proper treatment and exemptions."

C. Hearing Analysis.

As a threshold issue, it is the Taxpayer's responsibility to establish that the assessment of sales 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" *Rhoades v. Indiana Dep't of State Revenue*, 774 N.E.2d 1044, 2047 (Ind. Tax Ct. 2002).

Taxpayer is in the business of slitting and/or modifying coils of metal. It does so by means of equipment located and utilized at its Indiana facility. 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 metal coils - 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 equipment is exempt, Taxpayer relies on 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).

Taxpayer also relies [45 IAC 2.2-5-10](#) which states:

(a) In general, all purchases of tangible personal property by persons engaged in the processing or refining of tangible personal property are taxable. The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to manufacturing machinery, tools, and equipment used in direct production. It does not apply to materials consumed in production or to materials incorporated into the tangible personal property produced. Additionally, the exemption provided in this regulation [[45 IAC 2.2](#)] extends to industrial processors. An industrial processor, as defined in [IC 6-2.5-4-2](#), is one who:

- (1) acquires tangible personal property owned by another person;
- (2) provides industrial processing or servicing, including enameling or plating, on the property; and
- (3) transfers the property back to the owner to be sold by that owner either in the same form or as a part of other tangible personal property produced by that owner in his business of manufacturing, assembling, constructing, refining, or processing. (b) The state gross retail tax will not apply to sales of manufacturing machinery, tools, and equipment which are to be directly used by the purchaser in processing or refining tangible personal property.

(c) Purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in processing or refining 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 tangible personal property being processed or refined. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which processes or refines tangible personal property.

(Emphasis added).

The statutory authority for the above-cited regulation is found at IC § 6-2.5-5-3 which states in part:

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. IC § 6-2.5-5-3(b)

(Emphasis added).

Application of this the manufacturing and processing exemption requires determining at what point "production" or "processing" begins and at what point "production" or "processing" ends because equipment and supplies used before or after production or processing 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 or processing of goods are subject to sales/use tax unless the item has a direct and immediate effect on the goods produced, the item falls within the actual production process, and the item 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 in use at Taxpayer's Indiana facility is exempt because the equipment is directly used within the production or processing process, because the equipment has an immediate effect on the article being produced or processed, and because the product delivered to its customer is substantially different from the variety of metal coils delivered to that facility. [45 IAC 2.2-5-8\(c\)](#).

D. Conclusion.

The factual question is whether the slit metal coils delivered to its customers has undergone a "substantial change" into a finished product which has a "distinctive name, character, and use" as required by [45 IAC 2.2-5-10\(k\)](#). In considering the issue, 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 of the materials or even changing the location of materials from one place to another 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 audit conclusion was "wrong" because slitting and cutting to length the metal coils represents a "substantial change" in the coils it sells to its customers and to the coils which are owned by its customers.

On the threshold question of whether Taxpayer acts as a "manufacturer" when it slits metal coils it does not own or as an "industrial processor" when it slits metal coils on behalf of the coils' owners, Taxpayer's protest is sustained.

FINDING

Taxpayer's protest is sustained.

II. Gross Retail Tax - Exempt Equipment.

DISCUSSION

Given the conclusion set out in Part I above, the Taxpayer is required to establish that particular items of equipment and supplies are used within the manufacturing or processing of metal coils.

A. Forklift.

Taxpayer argues that its "counterbalance forklift" is exempt from sales tax because it "is an essential part of the production of our product." Taxpayer explains that the forklift "is used to load coils on to the coil processing equipment." Taxpayer further explains that the loading of these coils would ordinarily be done with a crane hoist but that because its production facility does not have sufficient ceiling height, it was not possible to install a crane hoist.

The Department readily concedes the practical necessity of the forklift. However, Taxpayer is reminded 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\(g\)](#).

IC § 6-2.5-5-3(b) provides:

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, including material handling equipment purchased for the purpose of transporting materials into such activities from an onsite location.

(Emphasis added).

The highlighted portion of the statute would seem to be squarely on point. However, that portion of the statute was added effective January 1, 2016, and the counterbalance forklift was acquired by Taxpayer in 2013. As such, the forklift's function is properly classified as pre-production equipment as defined under [45 IAC 2.2-5-8\(d\)](#). Neither the forklift - nor its parts such as batteries and supplies - were exempt from sales tax when the device was acquired.

B. Packaging and Shipping Supplies.

Taxpayer purchased \$23,961 in packaging and shipping supplies. These supplies were used to return slit steel to its owners. Taxpayer categorizes these transactions as "tolling" arrangements under which it slits steel coils the ownership of which is retained by its customers.

IC § 6-2.5-5-9(d) provides

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:

- (1) selling the contents that the person adds; or
- (2) shipping or delivering tangible personal property that:
 - (A) is owned by another person;
 - (B) is processed or serviced for the owner; and
 - (C) will be sold by that owner either in the same form or as a part of other tangible personal property produced by that owner in the owner's business of manufacturing, assembling, constructing, refining, or processing.

In this case, the shipping and packaging materials are exempt because they are used to deliver "tangible personal property that . . . is owned by another person [and] is processed or serviced for the owner"

C. Production Equipment and Supplies.

In Part I above, the Department agreed that when Taxpayer cuts and slits steel coils - whether owned by Taxpayer or by its customers - it acts as either a manufacturer or industrial processor entitled to claim the

exemption on equipment and parts "which have an immediate effect on the article being produced or processed . . ." [45 IAC 2.2-5-8\(g\)](#).

Bearing in mind that it is the Taxpayer's burden under IC § 6-8.1-5-1(c) to establish that any portion of the audit assessment is wrong, the Department is prepared to agree that Taxpayer has provided sufficient information to conclude that the following items fall within the exemption.

- Gear Box Motor for Braner Slitter 2
- Tapered Rollers for Braner Slitter 2
- Separator Discs
- Rubber Stripper Rings for Braner Slitter
- Nylon Mandrel rings for Wean II Slitting Line
- Entry Feed Roll-Braner 1 Part of Slitting Line
- Roll Cover-Braner 1
- BDI Controller/Wire Ties
- Color coded plastic shims - for Slitting Line
- Rectifier 300 Amp 200 Volt
- Programmable Core Cutter
- Rubber Stripper Rings for Braner Slitter
- Separator Discs - for Slitting Line
- Roller Assemblies-Braner 1
- Discs w/tabs-Wean 1-2
- Conveyor: 5'Lx6'4"Wx36"H-for Wean II slitting line
- Threaded Rt/Lft Shaft & sm Studs-Wean 2
- Knurled Rollers-Braner 1
- Spc Screw Shaft/Rec Nut/Washers-Braner 1
- 8 Pin Turntable - for Braner II slitting line
- Color coded plastic shims - used for slitting line

Taxpayer sought an exemption on certain other items which are not listed here. In the case of the remaining items such as "thermal tags," there is insufficient evidence to conclude with certainty that the items fall within any portion of the manufacturing exemptions noted here.

FINDING

As set out in Part II above, Taxpayer's protest is sustained in part and denied in part.

SUMMARY

Taxpayer acts as a manufacturer and/or industrial processor when it cuts and slits steel coils. As such, Taxpayer is entitled to claim the "manufacturing" exemption on a specifically designated list of equipment and supplies directly involved in that cutting and slitting process. Taxpayer has not met its burden of establishing that it is entitled to claim the exemption on any of the remaining items at issue.

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