

Letter of Findings: 04-20170002
Gross Retail and Use Taxes
For the Years 2013, 2014, and 2015

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

The Department found that Indiana Manufacturer was not entitled to claim the manufacturing exemption on items leased from a related company; Indiana Manufacturer failed to document that 150 leased items were directly used in the direct production of or had an immediate effect on the Indiana Manufacturer's products; although the leased items may have been necessary in manufacturing the products, the items did not necessarily have an "immediate effect" on those products.

ISSUE

I. Gross Retail and Use Tax - Manufacturing Exemption.

Authority: 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); 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); Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); [45 IAC 2.2-4-27\(a\)](#); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-8\(a\)](#); [45 IAC 2.2-5-8\(b\)](#); 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\(k\)](#).

Taxpayer argues it was not required to pay sales tax on lease payments made to a related company on the ground that it was leasing exempt manufacturing equipment.

STATEMENT OF FACTS

Taxpayer is an Indiana business which operates two manufacturing facilities. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer's tax returns and business records. The audit resulted in an assessment of additional sales and use tax. Taxpayer disagreed with a portion of 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 - Manufacturing Exemption.

DISCUSSION

The Department's audit found that Taxpayer had purchased items such as security cameras, shirts, barrels, and office supplies without paying sales tax. The audit concluded that such items were subject to sales/use tax because the items were not used in the direct production of Taxpayer's products. The audit also found that Taxpayer leased items of equipment which - without sufficient documentation - were subject to sales/use tax.

The issue is whether Taxpayer was required to pay sales tax on payments made to a related company ("Leasing Company"). Taxpayer maintains that the payments were exempt because the equipment leased from Leasing Company was used in the direct production of Taxpayer's manufactured products.

The Department's audit report explains the underlying lease transactions.

In 2013, the [T]axpayer was restructured and an equipment rental company, [Leasing Company], was

formed. All assets from [Taxpayer] were transferred to [Leasing Company]. Since the restructuring, [Taxpayer] leases all capital assets from [Leasing Company].

The report sets out the reasons why the Department concluded that Taxpayer should have paid sales tax on the lease payments.

[Taxpayer] provided annual equipment lease agreements to substantiate the yearly lease payments. However, the lease agreements do not itemize or identify specific assets. . . . Numerous requests were made in April, May, June, and July 2016 for documentation that identified the assets associated with each lease agreement. The [T]axpayer was notified . . . that the rental agreements would be subject to use tax without additional documentation. The additional documentation was not provided and . . . the [T]axpayer signed the Affirmation of Explanation and stated that there were no additional concerns regarding the audit.

Taxpayer argues that the lease payments were exempt and cites to [45 IAC 2.2-4-27\(a\)](#) as authority for that position. The cited regulation provides "[i]n general, the gross receipts from renting or leasing tangible personal property are taxable. This regulation [\[45 IAC 2.2\]](#) only exempts from tax those transactions which would have been exempt in an equivalent sales transaction."

Taxpayer states that the "equivalent sales transaction[s]" would have been exempt from sales tax because the leased equipment falls within the manufacturing exemption provided under [45 IAC 2.2-5-8](#). The regulation in part states:

- (a) In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. The exemption provided in this regulation [\[45 IAC 2.2\]](#) extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.
- (b) The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property.
- (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.

The issue is whether Taxpayer has established that the leased equipment was exempt from sales/use tax because the equipment is "directly used . . . in the direct production of tangible personal property."

The proposed assessment constitutes evidence that the Department's claim for the unpaid tax is valid, and each taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *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 n.9 (Ind. Tax Ct. 2012). In reviewing a taxpayer's argument, the Indiana Supreme Court has held, that when it examines a statute that an agency is "charged with enforcing . . . we 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).

[45 IAC 2.2-5-8](#), like all tax exemption provisions, is strictly construed against exemption from the tax. *Tri-States Double Cola Bottling Co. v. Dep't of State Revenue*, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); *Mynsberge v. Dep't of State Revenue*, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999). 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 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 particular property 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\(g\)](#).

Proper application of this particular exemption requires determining at what point "production" begins and at what point "production" ends. [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.

In addition, [45 IAC 2.2-5-8\(c\)](#) requires that exempt equipment have an immediate effect on the product being produced:

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.

Finally, [45 IAC 2.2-5-8\(k\)](#) specifies that, in order to qualify for the exemption, the articles being produced must 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.

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

The overarching issue is whether the specific items of equipment Taxpayer leased from Leasing Company are exempt because these items of equipment are "directly used in the production process because they have an immediate effect on the article being produced." IC § 6-2.5-5-3(b).

The list of purportedly exempt equipment includes such items as a fork lift, hardness test, "cut off saw," welder, paint gun, grinder, "toothsetter, vise, wash tank, pressure washer, sharpener, measurement system," and stamper. Taxpayer invites the Department to determine - without further explanation - that the list of some 150 items, without exception, are "exempt from further tax" because the items are "integral to the production process . . ." The Department must decline Taxpayer's invitation. It is possible that the items listed are "directly used by [Taxpayer] in direct production," that the items have an "immediate effect on the article being produced," and that each and every item "is an essential and integral part of an integrated process which produces tangible personal property." [45 IAC 2.2-5-8\(c\)](#). It is also possible that the items employed within Taxpayer's "integrated production process" and are not employed in "Pre-production [or] Postproduction activities" but from a bare listing of these tools, devices, and equipment, it is not possible to agree that the items are entitled to the exemption. Obviously, it is unlikely Taxpayer purchased items which were inessential, but Indiana law clearly provides that "[t]he fact particular property 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\(g\)](#).

Taxpayer also argues that the audit's calculations were incorrect because the audit based its assessment not on "actual lease payments" but were "annualized figures based [on] estimates of the first month lease . . . for that

particular year." In addition, Taxpayer argues that the audit assessed tax on some \$115,000 in assets "that reside[] outside the state of Indiana," and there is an approximately \$190,000 in "variance[s] due to erroneous audit[] assumption[s]."

The Department is aware of its responsibility to allow taxpayers a full and fair opportunity to challenge calculation assessments such as that addressed here. However, detailed calculation issues are ones best addressed during the audit when both Taxpayer and the field auditor have access to the original records. In this case, the Department must point out that the audit made "numerous requests" over a four-month period for detailed information on "assets associated with each lease agreement" and that "additional documentation was not provided"

Taxpayer has not met statutory burden under IC § 6-8.1-5-1(c) of establishing that the original assessment was "wrong." The Department is unable to substitute its judgment based on the information provided before, during, and after the administrative hearing.

FINDING

Taxpayer's protest is respectfully denied.

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