

Letter of Findings: 04-20170525.LOF
Gross Retail 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Stone and Aggregate Manufacturer was not entitled to an exemption from sales or use tax on the purchase of shotgun shells; although the shells may have been essential to the production of Stone and Aggregate Manufacturer's products, the shells were not an integral part of that manufacturing process.

ISSUE

I. Gross Retail and Use Tax - Supplies Consumed in Direct Production.

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 § 6-2.5-5-3(b); IC § 6-8.1-5-1(c); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 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); *Guardian Automotive Trim, Inc. v. Indiana Department of State Revenue*, 811 N.E.2d 979 (Ind. Tax Ct. 2004); *Rhoades v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); *Mynsberge v. Dep't of State Revenue*, 716 N.E.2d 629 (Ind. Tax Ct. 1999); *Tri-States Double Cola Bottling Co. v. Dep't of State Revenue*, 706 N.E.2d 282 (Ind. Tax Ct. 1999); *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399 (Ind. Tax Ct. 1991); [45 IAC 2.2-5-8](#); [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\(k\)](#); Audit Gram IF-027.

Taxpayer argues that its purchases of shotgun shells were exempt from sales and use tax because the shells were integral to the production of Taxpayer's stone and aggregate products.

STATEMENT OF FACTS

Taxpayer is a multi-state, multinational company in the business of processing and manufacturing stone and aggregate materials. Taxpayer's products are primarily used in the steel manufacturing and construction businesses.

Taxpayer operates a production facility in Indiana. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer's business records and tax returns. The audit resulted in an assessment of additional sales/use tax.

Taxpayer disagreed with the assessment on the ground that the Department erred in assessing tax on supplies directly used in its production process. Taxpayer submitted a protest to that effect.

Taxpayer declined the opportunity to participate in an administrative hearing but asked that the Department render a decision based on the information and explanation contained in its protest letter along with the information in the Department's audit report. This Letter of Findings results.

I. Gross Retail and Use Tax - Supplies Consumed in Direct Production.

DISCUSSION

Taxpayer manufactures and processes stone and aggregate materials. The issue is whether "shotgun shells" used to remove ash from its kilns are exempt from sales and use tax because the shotgun shells are directly used

in Taxpayer's processing of the stone and aggregate.

A. Audit Results.

The audit report described Taxpayer's use of the shotgun shells:

The inside of the kiln is shot with shotgun shells to remove ash rings that develop periodically due to the heating process that manufactures lime. Plant personnel constantly monitor the ash ring accumulation and shoot the kiln on an as needed basis. Generally, a kiln might be shot 6 times or more per year. If the ring grows too large, it can "choke" the kiln and decrease or stop production. During this pause, the kiln remains warm and can be started back up with relatively little interruption in production. Conversely, if the ash ring [was] not removed, the kiln would need to shut down for a period of days, followed by a day or longer to reheat and restart the kiln to resume production.

The Department's audit concluded that the shotgun shells were subject to sales and use tax because the use of the shells did not take place "during the production process" but their use was "an example of taxable maintenance activity."

As authority for its decision, the audit cited to [45 IAC 2.2-5-12\(f\)](#) which provides:

Purchases of materials consumed in manufacturing, processing, refining, or mining activities beyond the scope of those described in subsection B above [subsection (e) of this section] *are taxable*. Such activities include post-production activities; storage step) [sic]; maintenance, testing and inspection (except where in direct production); (except where essential and integral to the process system); management and administration; sales; research and development; exhibition of products; safety or fire prevention; space heating; ventilation and cooling equipment for general temperature control; illumination; shipping and loading.

(Emphasis added).

Subsection B, referred to immediately above provides:

The exemption provided by this regulation [[45 IAC 2.2](#)] applies only to tangible personal property to be directly consumed in direct production by manufacturing, processing, refining, or mining. It does not apply to machinery, tools, and equipment used in direct production or to materials incorporated into the tangible personal property produced. [45 IAC 2.2-5-12\(b\)](#).

As a result, the audit assessed use tax on the shotgun shells.

B. Taxpayer's Response.

Taxpayer disagrees with the Department's analysis arguing that the shotgun shells are "an integral part of the manufacturing process and therefore entitled to the manufacturing exemption." Taxpayer emphasizes that unless its kilns were cleaned, "[T]he kiln[s] will operate less efficiently."

Without this cleaning the quality of product being heated in the kiln will begin to suffer as the ash buildup in the kiln increases. At some point without this cleaning the product being heated in the kiln (various crushed aggregate limestone and other crushed aggregate stone products being dried in the kiln to a specific moisture content) will no longer meet the quality standards of their customers.

Taxpayer admits that the "kiln has to be turned off and is not operational when this [cleaning] process is being done" and that the "[cleaning] process does not come in direct contact with the product being sold to the end user." Nonetheless, Taxpayer cites to the Department's Audit Gram IF-027 which provides:

Cleaning compounds, integrated into a manufacturing process, which are not part of a regular maintenance program and which, if not used, have a negative impact on the product produced, *are exempt* from the Gross Retail Tax.

(Emphasis added).

Taxpayer also relies on the tax court's decision in *Guardian Automotive Trim, Inc. v. Indiana Department of State Revenue*, 811 N.E.2d 979 (Ind. Tax Ct. 2004), *transfer denied*, 831 N.E.2d 737 (Ind. 2005). In that case, the tax

court held that solvents used to clean paint masks were exempt because the use of the solvents occurred during Taxpayer's production of automotive parts. *Id.* at 985.

C. Hearing Analysis.

As a threshold issue, it is the Taxpayer's responsibility to establish that the 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 n.9 (Ind. Tax Ct. 2012). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. 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, 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). In effect and practice, the use tax is functionally equivalent to the sales tax. See *Rhoads v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

Taxpayer is in the business of manufacturing and processing stone and aggregate materials. 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 stone and aggregate - are taxable. [45 IAC 2.2-5-8\(a\)](#).

However, the Department's regulation, [45 IAC 2.2-5-8](#), explains that a taxpayer is entitled to purchase machinery, tools, and equipment without 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." The regulation further 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.

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 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.

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

The issue is whether the shotgun shells are exempt because these shells are "directly used in the production process because they have an immediate effect on the article being produced." [45 IAC 2.2-5-8\(c\)](#); IC § 6-2.5-5-3(b).

IC § 6-2.5-5-3(b) 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 does not disagree with Taxpayer that the shotgun shells appear to be an important part of Taxpayer's stone and aggregate production process. However, the shotgun shells do not meet the criteria necessary for the items to be reasonably classified as "exempt." However essential the shotgun shells may be, these shells do not have an "immediate effect" on Taxpayer's stone and aggregate products and are not utilized within and during the production process. The Department does not agree with Taxpayer's reliance on Audit Gram IF-027 because the exemption is applicable to cleaning materials which are "integrated into a manufacturing process." In Taxpayer's case, the shotgun shells are used before or after the actual process of producing its stone and aggregate products.

Similarly, the Department rejects Taxpayer's reliance on *Guardian Automotive* because the use of the shotgun shells - unlike the use of solvents in *Guardian* - was neither synchronized with or an essential and integral part of the production of Taxpayer's various stone products. *Guardian*, 811 N.E.2d at 985.

The Department notes that the law mandates that the "manufacturing" exemption statute be "strictly construed against exemption from the tax." *Tri-States*, 706 N.E.2d at 283; [45 IAC 2.2-5-8\(g\)](#). In applying that standard, the Department concludes that the Taxpayer has not met its burden of establishing that the audit assessment was wrong. IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is respectfully denied.

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