

Letter of Findings: 04-20170108
Use Tax
For the Years 2013 and 2014

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Plastic product manufacturer's purchases of liner carts, cleaning supplies and services should not be included as taxable purchases while purchases of label applicators, shipping labels and epoxy flooring were properly included as taxable purchases.

ISSUE

I. Use Tax - Imposition.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-4-1; IC § 6-2.5-5-1; IC § 6-2.5-5-3; IC § 6-2.5-5-4; IC § 6-2.5-5-6; IC § 6-8.1-5-1; *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *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, 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); *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Indiana Dep't of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988); *Aztec Partners, LLC v. Indiana Dep't of State Revenue*, 35 N.E.3d 320, 326 (Ind. Tax Ct. 2015); *Guardian Auto Trim, Inc. vs. Indiana Dep't of State Revenue*, 811 N.E.2d 979 (Ind. Tax Ct. 2004); [45 IAC 2.2-2-1](#); [45 IAC 2.2-3-4](#); [45 IAC 2.2-4-2](#); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-12](#); [45 IAC 2.2-5-14](#).

Taxpayer protests the Department's assessment of use tax on certain capital asset purchases and the inclusion of certain expenses in the Department's sample of additional taxable purchases.

STATEMENT OF FACTS

Taxpayer is an Indiana LLC which manufactures plastic parts to be used to contain items for human consumption. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer's business records for tax years 2013 and 2014. The Department determined that Taxpayer purchased some tangible personal property to be used during the course of its business without paying sales tax or self-assessing and remitting the use tax. As a result, the Department assessed additional use tax on these purchases.

Taxpayer protested the use tax assessed on its purchases of certain capital assets as well as the inclusion of certain purchases in the Department's sample of additional taxable purchases. An administrative hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Use Tax - Imposition.

DISCUSSION

The Department's audit determined that certain of Taxpayer's capital asset purchases were subject to use tax. Taxpayer claims that these assets were exempt from tax as they were "used directly in and are essential and integral to the production process." The Department sampled Taxpayer purchases and reviewed the related invoices to determine whether or not sales or use tax was paid. Taxpayer protests the inclusion of certain expenses in this sample.

As a threshold issue, all tax assessments are *prima facie* evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette*

Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012). Thus, the taxpayer is required to provide documentation explaining and supporting its challenge that the Department's assessment 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); see also *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). When an agency is charged with enforcing a statute, the jurisprudence defers to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014).

Indiana imposes a sales tax on retail transactions made in Indiana. IC § 6-2.5-2-1(a); [45 IAC 2.2-2-1](#). A retail transaction is a transaction made by a retail merchant that constitutes "selling at retail." IC § 6-2.5-1-2(a). Selling at retail occurs when a person "(1) acquires tangible personal property for the purpose of resale; and (2) transfers that property to another person for consideration." IC § 6-2.5-4-1(b). A person who acquires tangible personal 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). Tangible personal property purchased in a retail transaction is subject to use tax when the tangible personal property is "stored, used or otherwise consumed in Indiana . . . unless the Indiana state gross retail tax has been collected at the point of purchase." [45 IAC 2.2-3-4](#). When sales tax is not paid as a part of a retail transaction, use tax will be imposed unless the purchase is eligible for an exemption.

Use of tangible personal property in Indiana could be exempt from Indiana use tax if the sales tax is paid or collected at the time of the purchase pursuant to IC § 6-2.5-3-4 and [45 IAC 2.2-3-4](#). There are also various tax exemptions available outlined in [IC 6-2.5-5](#). 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 (internal citations omitted). Thus, in applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dep't of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

A. Capital Assets

Taxpayer claims that its purchase of Label Applicators ("Applicators") and Liner Carts ("Carts") are exempt as "they are used directly in and are essential and integral to the production process." Taxpayer cites IC § 6-2.5-5-3(b) and IC § 6-2.5-5-4 in support of its statement.

IC § 6-2.5-5-3(b) states:

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.

Further, IC § 6-2.5-5-4 provides:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for his direct use in direct production of the machinery, tools, or equipment described in section 2 or 3 of this chapter.

1. Label Applicators

In the hearing, Taxpayer explained that the applicators are essential and integral because without the labels the applicators apply, the products do not meet customer specifications. The audit explained that the applicators are used outside the manufacturing process and that "[t]here was a label printer where sales tax was paid on all the charges except freight and a label printer that was not taxed at all."

Under [45 IAC 2.2-5-8](#):

(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 produced 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 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 purchase 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.**

...

(g) 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 . . . the property must also be an integral part of an integrated process which produces tangible personal property.

(Emphasis added).

In this instance, Taxpayer claimed that its purchase and use of the applicators was essential and integral to the production process, because without the labels the products do not meet customer specifications. Despite this, Taxpayer's purchase and use of the applicators does not qualify for exemption because they do not affect the products directly. While the products may not meet customer specifications without the labels, this "does not itself mean that the property 'has an immediate effect upon the article being produced.'" [45 IAC 2.2-5-8](#).

2. Liner Carts

The audit report explains that Taxpayer has a two part manufacturing process. First is the manufacture of the plastic part and second is the pressing of liners into the part so that the plastic piece "will adequately seal after the product is placed into the container." The plastic part manufactured in step one may be stored for a period of time until the liners are ready.

The audit report describes the Carts' role in this process, explaining that Taxpayer "uses [C]arts to obtain the rolls of liner material from the warehouse, move them to the stamping machine and holds the rolls as they are fed into the stamping machine." The audit cites to [45 IAC 2.2-5-8\(f\)\(1\)](#) which states "Tangible personal property used for moving raw materials to the plant *prior to their entrance into the production process* is taxable." (*Emphasis added*). According to [45 IAC 2.2-5-8\(d\)](#), 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" Taxpayer's products are not in their "completed form" until the liner has been inserted. Thus, [45 IAC 2.2-5-8\(f\)\(1\)](#) does not apply.

The audit report also argued that under [45 IAC 2.2-5-8\(g\)](#), the Carts "have no immediate effect upon the liners before or during the stamping process[,]" thus, the Carts are taxable. However, property is deemed to have an immediate effect on a product "if it is an essential and integral part of an integrated process which produces tangible personal property." [45 IAC 2.2-5-8\(c\)](#). While the Carts must have an immediate effect, that effect does not have to be transformational. "[E]ven though [a] taxpayer's equipment [does] not transform its property, the equipment [is] essential and integral to the process of transformation [if] no marketable product would have resulted without it." *Aztec Partners, LLC v. Indiana Dep't of State Revenue*, 35 N.E.3d 320, 326 (Ind. Tax Ct. 2015). Thus, the Carts used to transport liner rolls to stamping machines and hold those rolls as they are fed into the machines are an essential and integral part of an integrated process and are partially exempt from tax. When the Carts are used to move liners to the production line, they are not used for an exempt purpose. However, once the Carts are placed in the production process, their use is exempt. Because the Carts serve two purposes - one exempt, one not - they will be taxed at only fifty percent. The Department's supplemental audit review will adjust the assessments accordingly.

B. Purchases

In order to review Taxpayer's purchases, the Department and Taxpayer agreed to use a statistical sample. A sample of purchases and related invoices was pulled and the Department reviewed the invoices for errors. A sample error rate was then calculated by dividing taxable purchases by the entire sample. The sample error rate was multiplied by the total purchases of the Taxpayer to arrive at the assessment amount. Taxpayer now argues that some of these purchases should have been "excluded" from the sample. Rather than exclude these items from the sample, if the Department determines that the items are exempt, the sample error rate calculation will be adjusted to remove those purchases from the numerator.

1. Property used or consumed within the manufacturing process

Taxpayer points to four types of purchases within the sample which it claims represents "[p]roperty used or consumed within the manufacturing process[,]" the inclusion of which "overstat[es] the additional taxable purchases-expenses." These purchases are discussed below.

a. Cleaning Supplies

In the hearing Taxpayer explained that a residue can build up in molds of their machines causing defects in the plastic parts Taxpayer produces. The audit report describes that these molds are removed from the machine and are cleaned. This cleaning is a "routine maintenance and the materials used in the cleaning process are taxable . . . [as t]angible personal property consumed in maintenance activities is subject to tax per [45 IAC 2.2-5-12](#)."

[45 IAC 2.2-5-12](#) provides:

- (a) The state gross retail tax shall not apply to sales of any tangible personal property consumed in direct production by the purchaser in the business of producing tangible personal property by manufacturing, processing, refining, or mining.
- (b) 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.
- (c) The state gross retail tax does not apply to purchases of materials to be directly consumed in the production process or in mining, provided that such materials are directly used in the production process; i.e., they have an immediate effect on the article being produced. The 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.
- (d) Pre-production and post-production activities.
 - (1) Direct consumption 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 process has altered the item to its completed form, including packaging, if required.
 - (2) "Direct use in mining" begins with the drilling of the shaft or well or the first removal of overburden in surface mining or quarrying. It ends when the item being mined or extracted has been physically removed from the mine, well, or quarry.
- (e) "Have an immediate effect upon the article being produced or mined." Purchases of materials to be consumed during the production or mining process are exempt from tax, if the consumption of such materials has an immediate effect upon the article being produced and mined, or upon machinery, tools, or equipment which are both used in the direct production or mining process and are exempt from tax under these regulations [\[45 IAC 2.2\]](#).
- (f) Other taxable transactions. *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.*

(g) "Consumed" as used in this regulation [[45 IAC 2.2](#)] means the dissipation or expenditure by combustion, use, or application and does not mean or include the obsolescence, discarding, disuse, depreciation, damage, wear or breakage of tools, dies, equipment, machinery, or furnishings.

(Emphasis added).

The Indiana Tax Court addressed this issue in the 2004 case of *Guardian Auto Trim, Inc. vs. Indiana Dep't of State Revenue*, 811 N.E.2d 979 (Ind. Tax Ct. 2004). In that case, Guardian, an automotive component manufacturer, had a manufacturing process in which plastic parts were made and then stored. After being stored for approximately three days, "the plastic parts were then sprayed with 'resist,' a coating that prevented the adhesion of electroplating metals and chemicals." A mask was used to cover certain areas of the plastic part to make sure that the resist was applied only to the appropriate areas. Guardian cleaned these masks "after every 15 to 50 uses" to prevent a build-up that would cause defects on the plastic parts. The Department conducted a sales tax audit of Guardian and noted that Guardian had not paid sales tax on its purchase of "mask processing equipment and supplies," thus the Department assessed Guardian with use tax.

The Tax court concluded that "the painting of the molded plastic parts is an integral part of Guardian's manufacture . . . it is part of a continuous process by which the plastic is placed in its finished form as automotive trim components" Therefore, the Tax Court concluded that the masks were tax exempt. In determining that the mask processing or cleaning equipment was also exempt, the Tax Court stated; "In a similar vein, the process of cleaning the masks is an integral part of Guardian's manufacture . . . the cleaning of the masks is done specifically for the purpose of properly applying electroplate to the parts. If Guardian did not 'clean' the masks, Guardian would only be able to produce [fifteen] to [fifty] marketable automotive trim components; the rest would be rejected by Guardian's customers and therefore rendered worthless." Because the mask cleaning equipment was "essential and integral to the overall production of Guardian's automotive trim components," it was deemed exempt by the Tax Court.

Here, Taxpayer has molds that it uses to create certain plastic parts. Over time residue can build up in the molds causing defects in the plastic parts. Like the masks in *Guardian*, depending on use, during the production process these molds are occasionally removed from the machine and are cleaned. The cleaning of the molds is not merely routine maintenance. Like the masks in *Guardian*, if the molds are not cleaned, Taxpayer is only able to produce a limited amount of marketable products. Thus, the mold cleaning supplies are essential and integral to the overall production of Taxpayer products and are exempt. The Department's supplemental audit review will adjust the sample error rate calculation accordingly.

b. Shipping Labels

In the hearing Taxpayer explained that it places a label on the shipping carton which is required by both the U.S. Food and Drug Administration ("FDA") and Taxpayer's customers. These labels list the part number, description and code in case of a recall. The labels are also used for proper storage in Taxpayer's storage facility and for tracking of shipments. The audit noted that the labels "have no effect upon the article being produced and the labeling process is a step removed from the manufacturing process." The audit concludes that the labels "serve as shipping labels affixed to shipping containers, not the product sold."

Taxpayer does not cite to a specific statute or regulation to support its claim that the shipping labels are exempt. Taxpayer does generally refer to IC § 6-2.5-5-1, 45 IAC § 2.2-5-12(a); 45 IAC § 2.2-5-12(g), and IC § 6-2.5-5-3. The Department cannot make Taxpayer's argument for them. However, the Department notes that the shipping labels do not qualify for exemption under IC § 6-2.5-5-6 which, in relevant part states:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for **incorporation as a material part of other tangible personal property which the purchaser manufactures, assembles, refines, or processes for sale in his business.**
(Emphasis added).

[45 IAC 2.2-5-14](#) further explains:

(d) The purchase of tangible personal property which is to be incorporated by the purchaser as a material or an integral part is exempt from tax. "Incorporated as a material or an integral part into tangible personal property for sale by such purchaser" means:

(1) That the material must be **physically incorporated into and become a component of the finished**

product;

(2) The material must constitute a material or an integral part of the finished product; and

(3) The tangible personal property must be produced for sale by the purchaser.

(e) Application of general rule.

(1) Incorporation into the finished product. The material must be physically incorporated into and become a component part of the finished product.

(2) Integral or material part. The material must constitute a material or integral part of the finished product.

(3) The finished product must be produced for sale by the purchaser.

(Emphasis added).

In addition, under [45 IAC 2.2-5-8](#) (g):

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 . . . the property must also be an integral part of an integrated process which produces tangible personal property.

The labels in question are not incorporated into the Taxpayer's product and the fact that the labels are required by both the FDA and Taxpayer's customers does not mean that the labels are an integral part of an integrated process which produces tangible personal property. Rather, the labels are placed on shipping cartons, outside of the integrated production process. The labels therefore, are not exempt. Taxpayer is denied in relation to its shipping label claim.

c. Service/Labor

Taxpayer argues that the sample includes an invoice which was purely for non-taxable services and labor. Taxpayer provided a copy of the invoice and the Department agrees that the invoice was solely for services and labor. Under [45 IAC 2.2-4-2](#)(a), "services in respect to property not owned by the person rendering such services are not 'transactions of a retail merchant constituting selling at retail,' and are not subject to gross retail tax." Therefore, the Department's supplemental audit review will adjust the sample error rate calculation accordingly.

d. Liner Carts

Taxpayer notes that within the sample are invoices for liner carts which were determined to be fifty percent exempt in section A.2 above. The Department's supplemental audit review will adjust the sample error rate calculation to reflect this determination.

2. Epoxy Flooring

Taxpayer notes that an invoice for epoxy flooring was included in the sample and asks that this invoice be removed from the sample as it is a nonrecurring expense that "distorts the statistical sample and should be treated as a onetime expense item" The audit addressed Taxpayer's request stating "There are always one-time expenses in any given year and these are representative of those other one-time expenses that did not show-up on the pull list. In addition, . . . this expense occurred during the audit time frame of 2013 and 2014 and is not being projected into periods beyond that point" The Department agrees with the audit report. Samples are designed to take into account one-time expenses that may have occurred. It is likely that there were some one-time expenses that occurred in the audit period that were not part of the sample; the epoxy flooring expense accounts for those as well. Therefore, one-time expenses are not generally removed from Department samples.

SUMMARY

Liner carts should not be included in taxable assets but label applicators are properly included as taxable. Cleaning supplies, service invoices and liner carts should be removed from the sample of taxable purchases but shipping labels and epoxy flooring should remain in the sample.

FINDING

Taxpayer is sustained in part and denied in part.

