

Final Order Denying Refund: 04-20181629
Adjusted Gross Income Tax
For Tax Year 2014 - 2016

NOTICE: IC § 4-22-7-7 permits the publication of this document in the Indiana Register. The publication of this document provides the general public with information about the Indiana Department of Revenue's official position concerning a specific set of facts and issues. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Final Order Denying Refund.

HOLDING

Indiana business was not entitled to an exemption from sales tax on utility purchases made as the utilities pertained to processes that took place outside of the production process and were not essential and integral to the production process.

ISSUE

I. Indiana Sales Tax - Imposition.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-5-2; IC § 6-2.5-1-27; [IC 6-2.5-5](#) et. seq; IC § 6-2.5-5-5.1; *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 97 (Ind. Ct. App. 1974); *Indiana Dep't of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988); *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 Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520,525 (Ind. 1983); *Guardian Automotive Trim, Inc. v. Ind. Dep't of Revenue*, 811 N.E.2d 979 (Ind. Tax 2005); *Graham Creek Farms v. Ind. Dep't of State Revenue*, 819 N.E.2d 151 (Ind. Tax 2004); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-13](#); LOF 04-20160439; 21 C.F.R. § 110.35; 21 C.F.R. § 117.35; 21 C.F.R. § 110.80; 21 C.F.R. § 117.80.

Taxpayer protests the Department's partial refund denial for the 2014 - 2016 tax years.

STATEMENT OF FACTS

Taxpayer is an Indiana-based processor and wholesaler of fruits and vegetables. In December of 2017, Taxpayer filed a Claim for Refund ("GA-110L") of \$116,487.33 for sales tax it paid on utilities purchased for use in its facilities for tax years 2014, 2015, and 2016. In April of 2018 the Indiana Department of Revenue ("Department") approved a portion of the claim, but denied \$23,236.85 of the claim, in part because of Taxpayer's calculation error, and in part because the Department determined that certain of the meters were not exempt because their use fell outside the production process.

Taxpayer filed a timely protest and an administrative hearing was held. This Final Order Denying Refund results. Additional facts will be provided as necessary.

I. Indiana Sales Tax - Imposition.

DISCUSSION

Taxpayer protested the Department's partial denial of its refund claim. Specifically, Taxpayer claimed that it is entitled to a total refund because the utilities at issue were exempt from sales tax as they were predominantly used in production.

Indiana sales tax is imposed by IC § 6-2.5-2-1:

- (a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.
- (b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

To trigger imposition of Indiana's sales tax, tangible personal property ("TPP") must be acquired in a retail

transaction. According to IC § 6-2.5-1-27, TPP ". . . includes electricity, water, gas, steam, and prewritten computer software."

When a person acquires utilities such as water and gas, the purchase is subject to Indiana sales tax, unless certain exemptions apply. A statute which provides a tax exemption, however, is strictly construed in favor of taxation. *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). In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against exemption." *Indiana Dep't of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). When a taxpayer challenges the taxability of a transaction, the taxpayer is required to provide documentation explaining and supporting its challenge. 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).

There are various sales tax exemptions outlined in [IC 6-2.5-5](#) *et. seq.* Under IC § 6-2.5-5-2:

- (a) Transactions involving agricultural machinery, tools, and equipment are exempt from state gross retail tax if the person acquiring that property acquires it for the person's **direct use in the direct production, extraction, harvesting, or processing of agricultural commodities**, and including material handling equipment purchased for the purpose of transporting materials into such activities from an onsite location.
- (b) Transactions involving agricultural machinery or equipment are exempt from the state gross retail tax if:
 - (1) the person acquiring the property acquires it for use in conjunction with the production of food and food ingredients or commodities for sale;
 - (2) the person acquiring the property is occupationally engaged in the production of food or commodities which the person sells for human or animal consumption or uses for further food and food ingredients or commodity production; and
 - (3) the machinery or equipment is designed for use in gathering, moving, or spreading animal waste.

Emphasis added.

Also relevant is IC § 6-2.5-5-5.1, which states:

- (a) As used in this section, [TPP] includes electrical energy, natural or artificial gas, water, steam, and steam heat.
- (b) Transactions involving [TPP] **are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other [TPP]** in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture. This exemption includes transactions involving acquisitions of [TPP] used in commercial printing.

Emphasis added.

Therefore, TPP is exempt from Indiana sales tax if the TPP is acquired for direct use or consumption in the direct production of other TPP. "[T]he test for directness requires the [TPP] to have an 'immediate link with the product being produced.'" *Indiana Dep't of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520,525 (Ind. 1983). "'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." [45 IAC 2.2-5-8](#).

The exemption for direct consumption in production is outlined at [45 IAC 2.2-5-13](#), which, in relevant part, states:

- (a) The state gross retail tax shall not apply to sales to [TPP] as a material which is to be directly consumed in direct production by the purchaser in the business of producing agricultural . . . commodities.
- (b) General Rule. Purchases of materials to be directly consumed by the purchaser in the business of

producing [TPP] are exempt from tax provided that such materials **are directly used in the production process; i.e., they have an immediate effect upon the commodities being produced. Property has an immediate effect on the commodities being produced if it is an essential and integral part of an integrated process which produces [TPP].**

...

(g)(1) "Have an immediate effect upon commodities being produced." Purchases of material to be consumed during production of commodities are taxable unless the consumption of such materials has an immediate effect upon either (1) the food or agricultural commodities being produced, or (2) machinery, tools, or equipment which are both used in direct production of commodities and are exempt from tax under these regulations [\[45 IAC 2.2\]](#). **The consumption of property has an immediate effect on the commodity being produced or the machinery, tools, or equipment engaged in direct production of commodities if the consumption is an essential and integral part of an integrated process which produces food or an agricultural commodity.**

Emphasis added.

In this instance, Taxpayer argues that its purchases of gas and water through certain meters were exempt from Indiana sales tax because the gas and water were "predominately utilized . . . in production." Specifically, Taxpayer states that "the gas is utilized in processes for cooking food or sanitizing the products and production processes. The water . . . is also used overwhelmingly for production purposes that include cooking and sanitation." The Department found that these meters were not exempt because the sanitation occurred during stoppages of production.

Taxpayer explains that "the production lines generally run from 6:00 a.m. until 7:00 p.m., [while] the bulk of the sanitation process is performed between 7:00 p.m. and 6:00 a.m. [However,] [t]he sanitation process is clearly part of the integrated production process since it is a required part of the process to produce a marketable product." Taxpayer points out that "[s]anitization utilizing hot water and chemicals is required for the production of processed fruits and vegetables as well as cooked and processed food products pursuant to FDA regulations."

Taxpayer directs the Department to 21 C.F.R. § 110.35 (d) and (e), which state:

(d) Sanitation of food-contact surfaces. All food-contact surfaces, including utensils and food-contact surfaces of equipment shall be cleaned as frequently as necessary to protect against contamination of food.

(1) Food-contact surfaces used for manufacturing or holding low-moisture food shall be in a dry, sanitary condition at the time of use. When the surfaces are wet-cleaned, they shall, when necessary, be sanitized and thoroughly dried before subsequent use.

(2) In wet processing, when cleaning is necessary to protect against the introduction of microorganisms into food, all food-contact surfaces shall be cleaned and sanitized before use and after any interruption during which the food-contact surfaces may have become contaminated. Where equipment and utensils are used in a continuous production operation, the utensils and food-contact surfaces of the equipment shall be cleaned and sanitized as necessary.

(3) Non-food contact surfaces of equipment used in the operation of food plants should be cleaned as frequently as necessary to protect against contamination of food.

(4) Single-service articles (such as utensils intended or one-time use, paper cups, and paper towels) should be stored in appropriate containers and shall be handled, dispensed, used, and disposed of in a manner that protects against contamination of food or food-contact surfaces.

(5) Sanitizing agents shall be adequate and safe under conditions of use. Any facility, procedure, or machine is acceptable for cleaning and sanitizing equipment and utensils if it is established that the facility, procedure, or machine will routinely render equipment and utensils clean and provide adequate cleaning and sanitizing treatment.

(c) Storage and handling of cleaned portable equipment and utensils. Cleaned and sanitized portable equipment with food-contact surfaces and utensils should be stored in a location and manner that protects food-contact surfaces from contamination.

21 C.F.R. § 117.35 (d) and (e) reflect these requirements:

(d) Sanitation of food-contact surfaces. All food-contact surfaces, including utensils, and food-contact surfaces of equipment, must be cleaned as frequently as necessary to protect against allergen cross-contact and against contamination of food.

(1) Food-contact surfaces used for manufacturing/processing, packing, or holding low-moisture food must be in a clean, dry, sanitary condition before use. When the surfaces are wet-cleaned, they must, when necessary, be sanitized and thoroughly dried before subsequent use.

(2) In wet processing, when cleaning is necessary to protect against allergen cross-contact or the introduction of microorganisms into food, all food-contact surfaces must be cleaned and sanitized before use and after any interruption during which the food-contact surfaces may have become contaminated. Where equipment and utensils are used in a continuous production operation, the utensils and food-contact surfaces of the equipment must be cleaned and sanitized as necessary.

(3) Single-service articles (such as utensils intended for one-time use, paper cups, and paper towels) must be stored, handled, and disposed of in a manner that protects against allergen cross-contact and against contamination of food, food-contact surfaces, or food-packaging materials.

(e) Sanitation of non-food-contact surfaces. Non-food-contact surfaces of equipment used in the operation of a food plant must be cleaned in a manner and as frequently as necessary to protect against allergen cross-contact and against contamination of food, food-contact surfaces, and food-packaging materials.

21 C.F.R. § 110.80 and 21 C.F.R. § 117.80 go on to require that all operations pertaining to food processing be "conducted in accordance with adequate sanitation principles." If food has become adulterated in some way, it must either be rejected or treated and processed to eliminate the contamination. Both 21 C.F.R. § 110.80 and 21 C.F.R. § 117.80 go on to describe general sanitation requirements, processes and controls in the processing and handling of food.

As support for its argument that, despite being utilized outside of the production process, the meters were still exempt because their use was a *required* part of the production process, Taxpayer turns to Departmental Letter of Findings 04-20160439. In that Letter of Finding ("LOF"), a business involved in the poultry/egg industry protested the imposition of Indiana use tax on certain of its purchases including purchases of epoxy flooring, pressure washers and a carton washer. In this case, the business, much like Taxpayer, pointed to several federal regulations regarding egg production requirements. One such regulation, provided that upon the discovery of any adulterated egg or egg products, the facility would be condemned, and if no appeal is made, the adulterated products were to be destroyed under the supervision of a federal inspector. If an appeal was made and the products could be reprocessed, that reprocessing would also be conducted under the supervision of a federal inspector.

In its analysis the Department found that given such requirements, "[t]axpayer . . . was compelled to clean its facilities and equipment on an ongoing basis in order to produce a marketable product. . . . Taxpayer's compliance [with the regulations was] required to produce a marketable product and [was] not routine maintenance." LOF 04-20160439, 2017022 Ind. Reg. 045170118NRA. The activities and TPP used to perform the cleaning activities were an essential and integral part of an integrated process because without those activities, the business could not use the production equipment to produce marketable agricultural products. It is important to note that the business' egg production processes were *not halted* in order to perform the cleaning activities. Because the business could not use their production equipment without continuous cleaning, and the production process was not halted to perform the cleaning activities, the Department determined that the epoxy flooring, pressure washers and carton washer were exempt from Indiana sales tax.

The Department's finding in LOF 04-20160439 is similar to the Tax Court's finding in *Guardian Automotive Trim, Inc. v. Ind. Dep't of Revenue*, 811 N.E.2d 979 (Ind. Tax 2005). In that case, an Indiana automotive component parts manufacturer, as a part of its manufacturing process, sprayed plastic parts with a special coating "that prevented the adhesion of electroplating metals and chemicals." *Id.* at 980. In order to appropriately apply the coating, Guardian used a mask. Guardian maintained four masks; two to use in production while the other two were being processed or cleaned. The masks were cleaned after every fifteen to fifty uses. Without the cleaning process, "the [coating] build-up caused the mask lines to become irregular which, in turn, caused a variety of defects on the plastic part . . . These defects rendered Guardian's products unmarketable to its customers." *Id.* at

The Indiana Tax Court found that:

It is indisputable that the painting of the molded plastic parts is an integral part of Guardian's manufacture of the automotive trim parts: it is part of a continuous process by which the plastic is placed in its finished form as automotive trim components, ready for delivery to Guardian's customers. Accordingly, the masks - which are used to paint the plastic parts - are exempt. In a similar vein, the process of cleaning the masks is an integral part of Guardian's manufacture of the automotive trim parts: the cleaning of the masks is done specifically for the purpose of properly applying electroplate to the parts. If Guardian did not "clean" its 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. Simply put, the masks cannot be used continuously without cleaning. Thus, the mask processing equipment, essential and integral to the overall production of Guardian's automotive trim components, is exempt. . . ."

Id. at 985. (Internal citations omitted).

Similarly, in *Graham Creek Farms v. Ind. Dep't. of State Revenue*, 819 N.E.2d 151 (Ind. Tax 2004), the Indiana Tax Court found that Graham's purchase of glass cleaner was exempt. The Court was swayed by testimony that the harvesting of soybeans is "a very dusty operation, and probably a half a dozen times a day you have to spray the [] front windows and side windows with the cleaner . . . so that you can see to operate the equipment." *Id.* at 164. Therefore, the Court found that "the glass cleaner is used in the soybean production process . . . [and] has an immediate effect on the article being produced." *Id.* Additionally, "without clear windows, the combine cannot be operated safely and the harvesting of soybeans from the field for further processing cannot occur." *Id.* In other words, similar to the masks in *Guardian*, the cleaner was exempt because it was used during Graham's production process and without it, production could not occur and marketable products could not be produced.

In LOF 04-20160439, *Guardian*, and *Graham*, the TPP was exempt because non-compliance with regulations or non-use of the TPP resulted in the destruction of the respective products; production was not possible without incorporating the exempt TPP into the production process. The meters at issue in the instant case are used outside of the production process and are not an essential and integral part of the production process. While it is true that cleaning and sanitization may be considered essential to the conduct of the business of food manufacturing, its required use by practical necessity or regulations does not itself mean that the related TPP have an immediate effect upon the article being produced. [45 IAC 2.2-5-8\(g\)](#). Merely complying with a government regulation is not the determining factor in whether or not TPP is exempt. Therefore, the meters at issue are not exempt and Taxpayer's protest is denied.

FINDING

Taxpayer's protest is denied.

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