

Memorandum of Decision: 04-20191122R
Sales and Use Tax
For the Years 2015, 2016, 2017, 2018

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 Memorandum of Decision.

HOLDING

Pet food manufacturer's purchases of cleaning supplies and equipment were exempt from sales tax; purchases of quality control testing supplies were exempt from use tax.

Issue

I. Sales Tax - Exemption.

Authority: IC § 6-8.1-9-1; IC § 6-2.5-1-2; IC § 6-2.5-2-1; IC § 6-2.5-4-1; IC § 6-2.5-5-5.1; IC § 6-2.5-5-3; *Guardian Auto Trim, Inc. vs. Indiana Dep't of State Revenue*, 811 N.E.2d 979; *Graham Creek Farms v. Ind. Dept. of State Revenue*, 819 N.E.2d 151 (Ind. Tax Ct. 2004); *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 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); [45 IAC 2.2-2-1](#).

Taxpayer argues that its purchases of cleaning supplies were exempt from Indiana sales tax, thus it is entitled to a refund of sales tax remitted to the Department.

II. Use Tax - Exemption.

Authority: IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-5-3; *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); [45 IAC 2.2-3-4](#); [45 IAC 2.2-5-8](#).

Taxpayer argues that items it purchased for quality control testing should be exempt from use tax as the testing was part of an integrated production process.

STATEMENT OF FACTS

Taxpayer is a pet food manufacturer with a manufacturing facility and a warehouse in Indiana. Taxpayer filed a claim for refund for use tax which it claimed it erroneously remitted to the Indiana Department of Revenue ("Department") and for sales tax remitted on exempt purchases. The claim was granted in part and denied in part. Taxpayer filed a timely protest of the partial denial. A hearing was held and this Memorandum of Decision results. Additional facts will be provided as necessary.

I. Sales Tax - Exemption.

DISCUSSION

Taxpayer filed a claim for refund for sales tax accrued and remitted to the Department for purchases of cleaning and sanitizing supplies. The Department denied the claims stating that the items were "not directly used in direct production." Taxpayer disagrees, stating that the cleaning and sanitizing supplies are "required by FDA food safety regulations . . . have a direct impact on the production of pet food . . . [and] are exempt products used directly in the production process. . . ." Therefore, Taxpayer believes it is entitled to refunds of sales tax paid on those transactions.

If a taxpayer has paid more tax than what the taxpayer determines is legally due, the taxpayer may file a claim for refund with the Department. IC §6-8.1-9-1(a). "The claim must set forth the amount of the refund to which the

person is entitled and the reasons that the person is entitled to the refund." *Id.* Thus, a taxpayer is required to provide documentation explaining and supporting his or her claim to refund. 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." *Dep't of State Revenue 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 allows for certain sales tax exemptions. One such exemption is found under IC § 6-2.5-5-3(b):

[T]ransactions 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

Additionally, IC § 6-2.5-5-5.1(b) provides:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it in direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture. . . .

However, a statute which provides a tax exemption 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).

During the hearing, Taxpayer's representative explained that it is continuously cleaning and sanitizing equipment used in the production of pet food in order to avoid contamination of its products. The cleaning supplies purchased for these purposes are different and separate from normal janitorial cleaning supplies. Prior to the refund period, the manufacturing facility operated all day, every day, and the "cleaning and sanitizing occurred continuously throughout the production process." However, new FDA regulations now require periodic "'clean breaks' meaning the cleaning and sanitization must occur between product cycles." Still, Taxpayer argues that the "clean breaks are necessary and integral to the pet food production process."

To support its case, Taxpayer points to the 1975 case of *Indiana Department of State Revenue v. American Dairy of Evansville, Inc.* 338 N.E.2d 698 (Ind. Ct. App. 1975). In that case the Court found that American Dairy's use of cleaning compounds "to retard growth of harmful bacteria . . . falls within the class of exempted items." *Id.* at 701. However, American Dairy's cleaning equipment such as "sponges, scouring pads, towels, mops and wipers" were deemed taxable as "[t]hough clearly essential to the cleaning process, their impact is arguably less direct than that of the cleaning compounds." *Id.*

The Department looks to a more recent case, the Indiana Tax Court 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.

A similar decision was reached by the Indiana Tax Court in *Graham Creek Farms v. Ind. Dept. of State Revenue*, 819 N.E.2d 151 (Ind. Tax Ct. 2004). In that case, Graham claimed an exemption "for purchases of cleaning chemicals and supplies used 'to clean parts of exempt equipment during the maintenance and repair thereof.'" *Id.* at 164. Because Graham provided "no evidence that this cleaning occurs during any production processes[.]" the Court determined the cleaning supplies were not entitled to exemption. *Id.* However, the Court determined that Graham was "entitled to an exemption for the purchase of glass cleaner it used to keep the windows of its combine clean while harvesting crops." *Id.* This determination was based on testimony that "combining 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.* Thus, the Court found that the glass cleaner was used in the soybean production process and that it had an immediate effect on the article being produced:

[W]ithout clear windows, the combine cannot be operated safely and the harvesting of soybeans from the field for further processing cannot occur. Accordingly, Graham is entitled to an exemption or its purchase of glass cleaner.

Id.

In both *Guardian* and *Graham* the Court exempted cleaning supplies because without the act of cleaning, the production processes could not move forward in a meaningful way. In *Guardian*, without the cleaning of the masks, Guardian could not produce sufficient marketable products. In *Graham*, production would essentially stop if the combine windows were too dusty and the combine could not be operated safely. Thus, the cleaning supplies in these cases were considered essential and integral parts of the production processes. Here, Taxpayer uses special cleaning compounds and equipment to make sure its production equipment remains sanitized. These cleaning compounds and equipment are separate from routine "janitorial" maintenance, and but for the FDA's "clean break" rule, the materials would be used continuously throughout production without halting the process. If Taxpayer does not regularly sanitize and clean the production equipment, it runs the risk of contaminating the pet food it produces. Like the taxpayers in *Guardian* and *Graham*, Taxpayer will have significantly less or no marketable product without this cleaning. Therefore, the chemicals, equipment and other materials used to clean the production equipment as part of a continuous production process is exempt from sales tax.

FINDING

Taxpayer is sustained.

II. Use Tax - Exemption.

DISCUSSION

Taxpayer filed a claim for refund for use tax accrued and remitted to the Department for purchases of quality control testing supplies including testing kits and test tubes. The Department denied the claim as the supplies were labeled as being related to research and development. However, according to Taxpayer, these purchases were mislabeled because no research and development is conducted at the Indiana manufacturing facility. Rather, these items are used for quality control, which is performed throughout the manufacturing process. As such, Taxpayer believes that these purchases were exempt and that Taxpayer should not have accrued and remitted use tax to the Department for these purchases.

Indiana 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](#). Use of tangible personal property may also be exempt when it was "acquired in a transaction that is wholly or partially exempt from the state gross retail tax under [IC 6-2.5-5](#), . . . and the property is being used, stored, or consumed for the purpose for which it was exempted." IC § 6-2.5-3-4(a)(2). There are 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).

Taxpayer purchased equipment such as tubes, test kits, and reagent "in order to perform quality control and routine testing for micro-contaminants on the pet foods being produced." Taxpayer noted that throughout the production process, samples of the product are taken and tested for quality control purposes in an onsite lab. Taxpayer believes that these purchases are exempt from use tax under IC § 6-2.5-3(b) which states:

[T]ransactions 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, Taxpayer claims that items it purchased for quality control purposes are exempt from sales and use tax under [45 IAC 2.2-5-8\(i\)](#) which states:

Testing and inspection. Machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt.

The examples listed under [45 IAC 2.2-5-8\(i\)](#) include:

Quality control equipment [which] is used to test the parts in a room in the plant separate from the production line. Because of the functional interrelationship between the testing equipment and the machinery on the production line and because of the product flow, the testing equipment is an integral part of the integrated production process and is exempt.

According to Taxpayer, it conducts quality control testing throughout the production process. Therefore, after review of Taxpayer's supporting documentation supplied in the protest process, the Department agrees that items such as testing kits, tubes, needles and reagent were used as part of an integrated production process and therefore qualified for the exemption described under [45 IAC 2.2-5-8\(i\)](#).

FINDING

Taxpayer is sustained.

SUMMARY

Taxpayer's purchases of cleaning supplies and equipment are exempt from Indiana sales tax. Taxpayer's purchases of quality control testing supplies are exempt from Indiana use tax.

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