

Letter of Findings: 04-20221054
Gross Retail and Use Tax
For the Years 2018, 2019, and 2020

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 was unable to agree with Indiana Valve Distributor that it met its burden of establishing that its purchase of items of tangible property used in its distribution business qualified for the use or sales tax manufacturing exemption or the "purchase for resale" exemption.

ISSUE

I. Gross Retail and Use Tax - Materials and Equipment Purchased by Valve Distribution Business.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-1-27; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC §§ 6-2.5-5 et seq.; IC § 6-2.5-5-4; IC § 6-2.5-5-8; IC § 6-8.1-5-1; *Anheuser-Busch Brewing Ass'n v. United States*, 207 U.S. 556 (1908); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Rhoads v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); *Indiana Dep't of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); [45 IAC 2.2-3-14](#); [45 IAC 2.2-5-3](#); [45 IAC 2.2-5-6](#); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-9](#); [45 IAC 2.2-5-10](#); [45 IAC 2.2-5-14](#); [45 IAC 2.2-5-15](#).

Taxpayer argues that certain equipment and supplies are exempt from sales or use tax on the ground that the equipment and supplies are used to provide its customers valves, actuators, and similar devices.

STATEMENT OF FACTS

Taxpayer is an Indiana company in the business of distributing valves, actuators, instruments, steam equipment, and the like. Taxpayer sells these items to construction companies, mechanical contractors, and manufacturers.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records including its sales and use tax returns. The audit resulted in an assessment of additional use tax. The assessment was approximately \$5,000.

Taxpayer disagreed with a portion of the assessment and submitted a protest to that effect. In its protest, Taxpayer maintains that the assessment should be reduced by approximately \$500. An administrative hearing was conducted by telephone during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Gross Retail and Use Tax - Materials and Equipment Purchased by Valve Distribution Business.

DISCUSSION

The issue is whether Taxpayer has met its burden of establishing that it purchased items which were or are exempt from either sales or use tax.

The Department's audit found that Taxpayer had purchased items which were not exempt from sales or use tax. For example, Taxpayer purchased "crates for storing valves, tapes, parts for cleaning and organizing machine and other items without payment of sales tax" Because the items were identified by Taxpayer as exempt, the Department issued notices of proposed assessment to which Taxpayer now objects.

A. Indiana Sales and Use Tax.

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 tax on the transaction. IC § 6-2.5-2-1(b).

In general, purchases of tangible personal property are subject to sales tax. [45 IAC 2.2-5-10\(a\)](#). Tangible personal property means personal property that: (1) can be seen, weighed, measured, felt, or touched; or (2) is in any other manner perceptible to the senses. IC § 6-2.5-1-27.

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 generally equivalent to the sales tax. See *Rhoades v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

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 are taxable. [45 IAC 2.2-5-8\(a\)](#).

With that "general rule" in mind, the Department will presume that purchases of tangible personal property - including items purchased and necessary for the distribution of valves - are subject to sales or use tax unless specifically exempted by statutes or regulations. [45 IAC 2.2-5-3\(b\)](#); [45 IAC 2.2-5-6\(a\)](#); [45 IAC 2.2-5-8\(a\)](#); [45 IAC 2.2-5-9\(a\)](#); [45 IAC 2.2-5-10\(a\)](#). Various sales tax exemptions are outlined in IC §§ 6-2.5-5 et seq. which are also applicable to use tax. [45 IAC 2.2-3-14\(2\)](#).

B. Exemptions from the Tax.

Taxpayer provided invoices for items which - according to Taxpayer - were not subject to either sales or use tax. In some instances, the Department's audit concluded that the item was purchased from a vendor which did not charge Indiana sales tax. In those instances, the audit assessed Taxpayer Indiana use tax.

In other instances, the audit did not address whether the item purchased was or was not subject to tax. However, Taxpayer now concludes that the item was exempt but that it had erroneously paid Indiana sales tax to the vendor at the time of purchase. In these instances, Taxpayer asks that the Department credit (or offset) the sales tax amount against the pending use tax assessment.

Taxpayer does not cite to any authority but explains that the item or items are "used for product assemblies that are sold," that the items are used for "cutting and heating valves," the items "[were] sold to an end user," the items were "wired up for operation when shipped to the customer," or the items constituted "cost of goods sold." For example, Taxpayer's representative explained that a customer will purchase a valve but asks that Taxpayer fit the valve with a remote-controlled actuator.

Based on the information provided, the Department will assume that Taxpayer relied on two different exemptions. (1) Directly Used in Industrial Processing or Manufacturing and (2) Purchased for Resale - and address them separately as follows.

1. Directly Used in Industrial Processing or Manufacturing.

While Taxpayer did not directly cite a statute or regulation in its protest, the Department will assume that Taxpayer relies on the sales/use tax "processing" or "manufacturing" exemptions. If so, Taxpayer presumably relies on the Department's regulation, [45 IAC 2.2-5-10](#), because Taxpayer does not manufacture the valves it distributes; instead, it may - or may not - depending on the customer's individual requirements, modify the particular valve needed by the customer. The exemption states:

(a) In general, all purchases of tangible personal property by persons engaged in the processing or refining of tangible personal property are taxable. The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to manufacturing machinery, tools, and equipment used in direct production. It does not apply to materials consumed in production or to materials incorporated into the tangible personal property produced. **Additionally, the exemption provided in this regulation [[45 IAC 2.2](#)] extends to industrial processors.**

An industrial processor, as defined in IC § 6-2.5-4-2(c), is one who:

- (1) acquires tangible personal property owned by another person;
- (2) provides industrial processing or servicing, including enameling or plating, on the property; and
- (3) transfers the property back to the owner to be sold by that owner either in the same form or as a part of other tangible personal property produced by that owner in his business of manufacturing, assembling, constructing, refining, or processing.

(b) The state gross retail tax will not apply to sales of manufacturing machinery, tools, and equipment which are to be directly used by the purchaser in processing or refining tangible personal property.

(c) Purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in processing or refining are exempt from tax; provided that such machinery, tools, and equipment *are directly used in the production process*; i.e., they have an immediate effect on the tangible personal property being processed or refined. The property has an immediate effect on the article being produced if **it is an essential and integral part of an integrated process which processes or refines tangible personal property. (Emphasis added)** See IC § 6-2.5-5-4.

The exemption upon which Taxpayer's claims rest is found at IC § 6-2.5-5-4 and only applies to machinery, tools, and equipment directly used by the purchaser in direct production. *Id.* The regulation provides that the "manufacturing exemptions" apply with equal weight to "industrial processors." Machinery, tools, and equipment are directly used in the production process if they have an immediate effect on the article being produced. [45 IAC 2.2-5-8\(c\)](#). A machine, tool, or equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. [45 IAC 2.2-5-8\(c\)](#). An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." [45 IAC 2.2-5-8\(c\)](#), example (1).

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

Closely related is the "incorporated into" exemption which exempts items which are purchased and then integrated into an item which the Taxpayer produces and then sells.

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

(a) The state gross retail tax shall not apply to sales of any tangible personal property which is to be incorporated by the purchaser as a material or an integral part into tangible personal property produced for sale by such purchaser in the business of manufacturing, assembling, refining or processing.

(b) The exemption provided by this regulation [[45 IAC 2.2](#)] applies only to tangible personal property to be incorporated as a material or an integral part into tangible personal property produced for sale by a purchaser engaged in the business of manufacturing, assembling, refining or processing. This regulation [[45 IAC 2.2](#)] does not apply to persons engaged in producing tangible personal property for their own use.

(c) This regulation [[45 IAC 2.2](#)] does not exempt from tax tangible personal property to be used in production, such as supplies, parts, fuel, machinery, etc., refer to Regs. 6-2.5-5-5(010) and 6-2.5-5-5(020) (dealing with material consumed in direct production) for the application of those regulations to taxpayers engaged in the production of tangible personal property.

(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"

2. Purchased for Resale.

Alternatively, Taxpayer believes that some of the items were exempt from either sales or use tax because the items were purchased for resale to its down-stream customers/consumers.

Taxpayer apparently relies on the sales/use tax exemption found at IC § 6-2.5-5-8, which provides that,

"Transactions involving tangible personal property . . . are exempt from the [sales and use] tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of his business without changing the form of the property." The exemption apparently sought is reiterated at [45 IAC 2.2-5-15](#), which states:

(a) The state gross retail tax shall not apply to sales of any tangible personal property to a purchaser who purchases the same for the purpose of reselling, renting or leasing, in the regular course of the purchaser's business, such tangible personal property in the form in which it is sold to such purchaser.

(b) General rule. Sales of tangible personal property for resale, renting or leasing are exempt from tax if all of the following conditions are satisfied:

- (1) The tangible personal property is sold to a purchaser who purchases this property to resell, rent or lease it;
- (2) The purchaser is occupationally engaged in reselling, renting or leasing such property in the regular course of his business; and
- (3) The property is resold, rented or leased in the same form in which it was purchased.

Taxpayer asks that the Department reconsider the Department's assessment of use tax on the items or - in instances in which Taxpayer paid Indiana sales tax at the time of purchase - grant an offset or "credit" against the original \$5,000 assessment.

C. Taxpayer's Burden of Proof.

Because Taxpayer's objections arose following the assessment of additional tax, it is the Taxpayer's responsibility to here establish that the 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).

When a taxpayer attempts to meet that statutory burden, the 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 original audit and investigative report, are entitled to deference.

A statute which provides any 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). 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).

The Department's regulation [45 IAC 2.2-5-8\(c\)](#) provides that materials are directly used in the production process if "they have an immediate effect on the article being produced." Property has an immediate effect "if it is an essential and integral part of an integrated process which produces tangible personal property." However, [45 IAC 2.2-5-8\(g\)](#) provides as follows:

The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced."

D. The Particulars, Analysis, and Conclusion.

Taxpayer seeks sales/use tax relief for particular items including but not limited to:

- Tool Kit
- Stainless Steel Rod
- Steel Pipe
- Set Screws
- Dowel Pin

- Steel Head Screws
- Lock Washer
- Zinc-Plated Hex Head Screw
- Steel Key Stock
- Slotted Spring Pins
- Quick Release Pin with Lanyard
- PVC Sheet
- Wire Marker Book
- 320-Watt LED Fixture
- Pendant Mount Kit
- Water Jet Paddle Orifice
- Gas Welding Rod
- Penetrating Lubricant
- Stainless Steel Threaded Plug
- Steel Chip-Clearing Tap
- Tap Wrench
- Heat-Shrink Tubing
- Three-Quarter Inch Collet

The Department does not dispute Taxpayer's assertion that the items above are necessary for the conduct of its valve distribution business. However, as noted above, [45 IAC 2.2-5-8\(g\)](#) provides that an item does not qualify for an exemption simply because "its use is required by law or by practical necessity" In addition, Taxpayer has not established that the ad hoc modification of a valve to meet a customer's specifications necessarily results from a functionally integrated process that produces the modified valve. [45 IAC 2.2-5-8\(c\)](#). Simply put, an automobile manufacturer's assembly line may well constitute an integrated production process entitling the manufacturer to claim an exemption for devices which have an immediate effect on the automobile being produced. [45 IAC 2.2-5-8\(c\)](#). However, a car dealer cannot claim the exemption on tools it uses to install a radio or CD player requested by a particular customer because the car dealer does not "manufacture" the car. Finally, Taxpayer's valve modifications do not result in a product which has undergone a "change in form, composition, or character" which results in a transformation of the valve into a different product having a distinctive name, character, and use. [45 IAC 2.2-5-8\(k\)](#).

The Supreme Court explained the general principle in *Anheuser-Busch Brewing Ass'n v. United States*, 207 U.S. 556 (1908) in which the brewery claimed an exemption for corks used to seal beer bottles. As the Court explained:

There must be transformation; a new and different article must emerge, "having a distinctive name, character or use." This cannot be said of the corks in question. A cork put through the claimant's process is still a cork. *Id.* at 562.

In applying that principle, the Department concludes that, while modified to comport with a particular customer's specifications, Taxpayer's valves remain just that; the valves remain valves.

The Department must also decline to accept Taxpayer's argument that it purchased the items for the purpose of selling those items to its customers. It would appear - and the Department will here assume - that metal screws, tubing, and PVC sheets are consumed to some degree in modifying the valves sold to its customers. The Department will also assume that Taxpayer's customers compensate Taxpayer for these purchases. However, Indiana law requires that in order to qualify for the "purchase for resale" exemption, the buyer must resell the same item it purchased.

[45 IAC 2.2-5-15](#) requires that the exemption applies to items which are purchased and then resold "in the same form in which it was purchased."

Taxpayer's customers do not buy steel screws, washers, tubing, or sheets of PVC. Taxpayer's customers purchase valves which may or may not have been modified to meet the customers' requirements. Certainly, Taxpayer may purchase metal valves which it stocks, makes available, and then resells to its customers. However, that is not the case here.

In order to obtain the relief sought, Taxpayer must plainly establish that the Department's use tax assessments were wrong as required under IC § 6-8.1-5-1(c). In addition and in order to qualify for the exemption, Taxpayer must "show a case, by sufficient evidence, which is clearly within the exact letter of the law." *RCA Corp.*, 310

N.E.2d 96, 101. In this instance, Taxpayer has not established the assessments were "wrong" or overcome the rule that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Kimball Int'l Inc.*, 520 N.E.2d at 456.

FINDING

Taxpayer's protest is respectfully denied.

June 13, 2022

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An [html](#) version of this document.