

Letter of Findings: 04-20221028
Gross Retail Tax
for Tax Years 2018 Through 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 Indiana Department of Revenue'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 This document is effective on its date of publication and remains in effect until the date is superseded or deleted by the publication of another document in the Indiana Register.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

Company was subject to sales and/or use tax on the purchase of equipment and supplies used in its refurbishing process and was not entitled to a refund.

ISSUES

I. Gross Retail Tax - Manufacturing Exemption.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-5-3; IC § 6-2.5-5-5.1; *Dept. of State Revenue v Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Rotation Products Corp. v. Indiana Dept. of State Revenue*, 690 N.E.2d 795 (Ind. Tax Ct. 1998); *Alloy Custom Products, Inc. v. Indiana Dept. of Revenue*, 26 N.E.3d 1078 (Ind. Tax Ct. 2015); [45 IAC 2.2-5-8](#).

Taxpayer argues that equipment and supplies were exempt from sales tax because they were purchased for direct use or direct consumption in an exempt manufacturing process.

II. Gross Retail Tax - Total Sales and Use Tax Credit.

Authority: IC § 6-8.1-9-1; IC § 6-8.1-9.5-2; *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014).

Taxpayer protests reduction of a claimed credit.

STATEMENT OF FACTS

Taxpayer is an Indiana business that acquires, refurbishes, and markets used video game discs and video game equipment. During an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had purchased some equipment without paying sales tax at the time of purchase or use tax later and had over-remitted use tax on some items. After the audit, the Department reconciled Taxpayer's total sales tax assessments and use tax credits for the tax years at issue. Taxpayer protested the Department's imposition of sales and/or use tax on the equipment purchases and its tax credit calculation. An administrative hearing was conducted by telephone during which Taxpayer's representative explained the basis for the protest. This Letter of Finding results. Additional facts will be provided as necessary.

I. Gross Retail Tax - Manufacturing Exemption.

DISCUSSION

As part of its audit, the Department reviewed Taxpayer's purchases of certain equipment and supplies, including a video game disc repair machine, buffing pads, and disc cleaning products. Taxpayer claimed the items were part of a manufacturing process and therefore exempt from sales and/or use tax. The Department found these items were used to clean video game discs for resale and were not part of a manufacturing process. The Department therefore assessed use tax on the items.

Taxpayer protested the Department's assessment, arguing the items were exempt because they were directly used or consumed in its refurbishment process. To support its position, Taxpayer provided a letter stating the repair machines and related supplies were part of a refurbishment process that was necessary for many of the discs to function properly and to meet customer expectations. Taxpayer also provided a sample listing of used

video game discs it purchased, refurbished, and sold along with the discs' corresponding purchase and resale prices.

As a threshold issue, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation of another party.'" *Dept. of State Revenue v Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014).

Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used or consumed in the state. IC § 6-2.5-2-1; IC § 6-2.5-3-2. 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. [45 IAC 2.2-5-8](#)(a). However, IC § 6-2.5-5-3(b) states:

Transactions involving manufacturing machinery, tools, and equipment . . . are exempt from the state gross retail tax if the person acquiring the property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

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 for direct consumption as a material to be consumed in direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture.

An exemption applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. *Id.* 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 piece of 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. *Id.* 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.

[45 IAC 2.2-5-8](#)(k) describes direct production as the performance of an integrated series of operations which transforms the matter into a form, composition, or character different from that in which it was acquired, and that the *change must be substantial resulting in a transformation of the property into a different and distinct product.*

Before Taxpayer can benefit from the exemption, Taxpayer must meet the threshold question of whether Taxpayer's activities qualify as a manufacturing process. A taxpayer can be considered a remanufacturer if the taxpayer's repair activity was directly involved in the creation of a product. *Rotation Products Corp. v Dept. of State Revenue*, 690 N.E.2d 795, 801 (Ind. Tax. Ct.1998). *Rotation Products* established four factors to be used in determining if repair activity rises to the level of remanufacturing:

- (1) The substantiality and complexity of the work,
- (2) The value of the article before and after repair,
- (3) The performance of the repaired article as compared to new, and
- (4) Whether the work performed was a normal part of the life cycle of the existing article.

Id. at 802-3.

The court in *Rotation Products* interpreted the four indicators in favor of a taxpayer which repaired and remanufactured roller bearings. *Rotation Products*' work was substantial and complex because it ground down the existing bearings then fabricated and fitted replacement parts to them. *Id.* at 803. The court found that the roller bearings had no value before repair, but after repair were transformed into a marketable product that was comparable to newly manufactured bearings. *Id.* at 803. Lastly, the court found that the process of grinding down the bearings and replacing certain parts went beyond "routine maintenance" and therefore was not a normal part of the bearing's life cycle. *Id.*

By contrast, in *Alloy Custom Products, Inc. v. Indiana Dept. of Revenue*, 26 N.E.3d 1078 (Ind. Tax Ct. 2015), the Indiana Tax Court denied a taxpayer's claim for refund on metered utilities consumed during the rehabilitation of tanker trailers. The court found that although Alloy's rehabilitation process was extensive and required 750 hours of work over six to eight weeks, the process was not substantial or complex because it did not create a new

product. *Id.* at 1084. Alloy argued that the tankers had no value prior to rehabilitation; however, the court found the used tankers had at least \$5,000 scrap value. *Id.* Finally, the court determined that Alloy's rehabilitation process was routine maintenance that could be performed multiple times throughout the normal lifecycle of the tanker. *Id.* at 1086.

As discussed in both *Rotation Products* and *Alloy Custom Products*, Taxpayer must satisfy all four components of the test to be considered a remanufacturer of video game discs in order to qualify for exemptions under IC § 6-2.5-5-3(b) and IC § 6-2.5-5-5.1(b). Taxpayer's refurbishment process does not meet the first prong of the *Rotation Products* test. Taxpayer purchased used video game discs, refurbished the discs, tested the discs, then repackaged and resold the discs to consumers. This process is far less complex than the 450-hour multi-week repair process in *Alloy Custom Products* and similarly did not result in the creation of a new product.

Additionally, Taxpayer provided documentation confirming the purchase and resale prices for some of the video game discs it refurbished. The used discs were purchased for \$20-25 and resold for \$65-\$70. Like the tanker trucks in *Alloy Custom Products*, the used discs had value in the marketplace prior to the refurbishment process as evidenced by Taxpayer's ability to purchase them. The game discs were not without retail value like the initial roller bearings in *Rotation Products Corp.* Taxpayer repackaged and resold the discs but did not replace missing parts or add new components to the product.

Finally, the refurbishment process was principally cleaning the gaming discs which is part of routine maintenance. Cleaning does not result in a substantial change that transforms the disc into a new product. Taxpayer in the instant case is perpetuating an existing product.

Taxpayer's refurbishment process must meet all four parts of the test set forth in *Rotation Products* to qualify as exempt. Taxpayer's refurbishment process fails to satisfy all four parts of the test. Taxpayer's contention that a portion of the purchases qualify for the direct consumption exemption under IC § 6-2.5-5-5.1 is not relevant because Taxpayer is not engaged in direct production. Taxpayer's purchases of the refurbishment machine and related materials were not exempt under IC § 6-2.5-5.3 because Taxpayer's process of refurbishing video game discs did not constitute direct production.

FINDING

Taxpayer's protest is denied.

II. Gross Retail Tax - Total Sales and Use Tax Credit.

DISCUSSION

Taxpayer protests the Department's Total Sales and Use Tax Credit calculation for the tax year 2019. Taxpayer argues that the Department erred in adjusting Taxpayer's Total Sales and Use Tax Credit for the period ending December 31, 2019. Taxpayer points to the Department's Audit Report ("Audit Report") issued September 28, 2021, which showed a credit due for \$11,277.18 and a Refund Offset Notice ("Notice") issued by the Department on September 30, 2021, which showed a credit due for \$8,974.54. Taxpayer requests the \$2,302.64 difference be refunded or applied to outstanding liabilities.

The Audit Report issued on September 28, 2021, covered tax years 2018 through 2020 and included a summary of the Department's use tax adjustment for each year. The Audit Report showed a total use tax adjustment in tax year 2019 for \$11,277.12. The Department subsequently issued a Notice to Taxpayer on September 30, 2021, that reported a refund credit for sales and/or use tax for tax year 2019 totaling \$8,974.54.

The difference between the 2019 use tax credit on the Audit Report and the subsequent Notice the Department produced is \$2,302.58. IC § 6-8.1-9.5-2 allows the Department to offset a taxpayer's refund to resolve an outstanding liability. A review of the Department's records shows the \$2,302.58 difference was applied to existing liabilities as follows: \$1,514.34 to Taxpayer's existing sales tax liability for the period ending December 2018 and \$788.24 to Taxpayer's existing sales tax liability for the period ending December 2020. The \$2,302.58 is not available to refund to Taxpayer because it was already applied to other, separate liabilities which were not part of the audited years and tax types.

FINDING

Taxpayer's protest is denied.

SUMMARY

Taxpayer is not entitled to a manufacturing exemption on purchases of equipment and supplies used in its video game refurbishment process. Taxpayer's Total Sales and Use Tax Credit was properly calculated for the period at issue and applied to existing tax liabilities.

July 29, 2022

Posted: 05/03/2023 by Legislative Services Agency
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