DEPARTMENT OF STATE REVENUE

04-20221047.LOF

Letter of Findings: 04-20221047
Use Tax
For The Years 2018 and 2019

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 (the "Department") 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Business provided documentation showing that certain items were tax exempt because they were directly used in the manufacturing; however, conveyor belts used for scrap removal were not part of the direct manufacturing process.

ISSUE

I. Use Tax - Assessment.

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 § 6-2.5-5-3; IC § 6-2.5-5-9; IC § 6-8.1-5-1; *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); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Rhoade v. Indiana Dept. of State Revenue*, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); *USAir, Inc. v. Indiana Dept. of State Revenue*, 623 N.E.2d 466 (Ind. Tax Ct. 1993); *Indiana Dept. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Indiana Dept. of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988); *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399 (Ind. Tax Ct. 1991); *Indiana Dept. of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983); 45 IAC 2.2-2-1; 45 IAC 2.2-5-8; 45 IAC 2.2-5-10; 45 IAC 2.2-5-16.

Taxpayer protests the assessment of use tax.

STATEMENT OF FACTS

Taxpayer is an out-of-state company that manufactures parts for the automotive industry. Taxpayer maintains two Indiana manufacturing facilities. The Indiana Department of Revenue ("Department") conducted an audit of both locations for tax years 2018 and 2019. During the audit process, Taxpayer and the Department agreed to use a statistical sampling method for each tax year. As a result of the audit, the Department assessed additional use tax for both locations for tax years 2018 and 2019.

Taxpayer protested the assessment. While the audit involved a review of items purchased for both Indiana locations, Taxpayer is only protesting assessments for specific items related to one location. No other items are being protested. Taxpayer requested resolution with a hearing, and an administrative hearing was held. This Memorandum of Decision results. Additional facts will be provided as necessary.

I. Use Tax - Assessment.

DISCUSSION

The Department conducted an audit of Taxpayer's two Indiana locations. Each location maintained a separate accounting system. After a review of separate statistical samples for each location, the Department assessed additional use tax for tax years 2018 and 2019. The Department determined that certain invoices showed Taxpayer purchased equipment, containers, and other non-manufacturing supplies without paying sales tax or self-assessing use tax. Taxpayer protested the assessment related to one of the locations. Specifically, Taxpayer disputes use tax is owed on certain storage bins, non-returnable packaging, banding steel, and conveyor belts that it believes are used in the manufacturing process.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. A proposed assessment is *prima facie* evidence that the Department's claim for the unpaid tax is valid. IC § 6-8.1-5-1(c). The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made. *Id.*; *See e.g., Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). An assessment, including a penalty assessment, is therefore presumed valid. A taxpayer must provide documentation explaining and supporting that the Department's position is wrong. Additionally, "[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).

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); 45 IAC 2.2-2-1. A person who acquires property in a retail transaction is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). Indiana also imposes a complementary excise tax called a "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). The use tax is a functional equivalent to the sales tax. *See Rhoade v. Indiana Dept. of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

The complementary relationship between sales and use tax ensures non-exempt retail transactions that escape sales tax liability remain taxed. *Id.*; *USAir, Inc. v. Indiana Dept. of State Revenue*, 623 N.E.2d 466, 468 (Ind. Tax Ct. 1993). If sales tax is paid at the time of the transaction, an exemption from use tax is granted under IC § 6-2.5-3-4. A statute which provides a tax exemption is strictly constructed against the taxpayer. *Indiana Dept. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 97 (Ind. Ct. App. 1974).

To trigger the imposition of Indiana's use tax, tangible personal property must be acquired in a retail transaction. A taxable retail transaction occurs when (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. *See* IC § 6-2.5-1-2; IC § 6-2.5-4-1(b) and (c); IC § 6-2.5-3-2(a). Generally, 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.

Under Indiana law, certain items or transactions may be exempt from tax if certain conditions are met. In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dept. of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). The party seeking the exemption must present sufficient evidence showing the exemption is within the exact letter of the law. *RCA Corp.*, at 101.

In general, 45 IAC 2.2-5-8(a) provides 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." IC § 6-2.5-5-3(b) provides an exemption from sales tax for transactions involving manufacturing machinery, tools, and equipment if the property is acquired for direct use in the direct manufacturing of other tangible personal property. IC § 6-2.5-5-3 states, in part,

> (b) Except as provided in subsection (d), transactions involving manufacturing machinery, tools, and equipment, including material handling equipment purchased for the purpose of transporting materials into activities described in this subsection from an onsite location, 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. (**Emphasis added**.)

See also 45 IAC 2.2-5-8(b).

Items must meet this "double direct" test to qualify for an exemption. As discussed in *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399 (Ind. Tax Ct. 1991), the "double direct" test inquiry focuses on the production process itself, broadly defined to encompass all the production steps involved in transforming a work in progress into a finished marketable product. *Id.* at 401. For example, the Indiana Supreme Court in *Cave Stone* broadly defined this process, stating that "the production or processing of the stone begins at the time of the initial stripping, drilling, and blasting at the quarry and ends at the time the stone is stockpiled." *Id.* quoting *Indiana Dept. of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520, 524 (Ind. 1983). Equipment meets the

double direct standard when it is used in an essential and integral part of an integrated production process. *Id*.

"Direct use in the production process" begins at the point of the first operation or activity that constitutes part of the integrated production process and ends at the point that the production has altered the item to its completed form. 45 IAC 2.2-5-8(d). Storage equipment used during the production process may be exempt if certain conditions are met under 45 IAC 2.2-5-8(e). Specifically, temporary storage equipment is not subject to tax if the equipment stores raw materials or finished goods while moving materials being manufactured from one machine to another or one production step to another. 45 IAC 2.2-5-8(e)(1). Additionally, if a storage facility or container is used to store materials or items undergoing production during the production process, the storage facility or storage container is considered temporary and not subject to tax. 45 IAC 2.2-5-8(e)(3).

The statistical sampling reviewed by the Department included a purchase of storage containers in Stratum 6, referenced by an invoice dated September 4, 2019, in the amount of $23,355.06. During the audit, the Department classified the storage containers as purchases of "other non-manufacturing supplies and equipment." During the administrative hearing, Taxpayer described the containers as "Work in Process Storage" and provided a purchase invoice for the transaction.

Taxpayer explained that the containers are used internally to hold steel parts that are moved from one step of the manufacturing process to another. Parts held in the containers are stamped in the press room but still require further processing. The parts are collected from the stamp press, placed in the containers, and moved to the plant's assembly area for additional manufacturing. The "second phase" of manufacturing consists of the stamped parts being welded to a nut or stud or several stamped parts being welded together. Once the parts are placed in the containers, the containers are moved through the plant via a special cart which positions the containers at a specific angle for release onto the second manufacturing line for additional processing.

Considering Taxpayer's explanation for how the storage containers are used in the manufacturing process, the containers are temporary storage equipment under 45 IAC 2.2-5-8(e)(1). Taxpayer's description is akin to Example 2 provided in 45 IAC 2.2-5-8(e) - "Parts undergoing various machining operations are transported from a machine operation to a storage rack where they are held for periods of time, as required by the processing schedule for the next machine operation in the integrated production process." Because the containers are used by Taxpayer during the manufacturing process, the storage containers are exempt.

Taxpayer also argues that certain purchases of non-returnable packaging should be tax exempt under IC § 6-2.5-5-9(d).

IC § 6-2.5-5-9 provides:

> (a) As used in this section, "returnable containers" means containers customarily returned by the buyer of the contents for reuse as containers.
>
> (b) Sales of returnable containers are exempt from the state gross retail tax if the transaction constitutes selling at retail as defined in IC 6-2.5-4-1 and if the returnable containers contain contents.
>
> (c) Sales of returnable containers are exempt from the state gross retail tax if the containers are transferred empty for the purpose of refilling.
>
> (d) Sales of wrapping material and empty containers are exempt from the state gross retail tax if the person acquiring the material or containers acquires them for use as nonreturnable packages for:
> (1) selling the contents that the person adds; or
> (2) shipping or delivering tangible personal property that:
> (A) is owned by another person;
> (B) is processed or served for the owner; and
> (C) will be sold by that owner either in the same form or as a part of other tangible personal property produced by that owner in the owner's business of manufacturing, assembling, constructing, refining, or processing.

Further guidance is provided by 45 IAC 2.2-5-16, which states, in part:

> (a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers

sold empty for refilling.

(b) In general, the gross proceeds from the sale of tangible personal property in a transaction of a retail merchant constituting selling at retail are taxable. This regulation [45 IAC 2.2] provided an exemption for wrapping materials and containers.

(c) General rule: The receipt from a sale by a retail merchant of the following types of tangible personal property are exempt from state gross retail tax:
(1) Nonreturnable containers and wrapping materials including steel strap and shipping pallets to be used by the purchaser as enclosures for selling tangible personal property.
(2) Deposit for returnable containers received as an incident to a transaction of a retail merchant constituting selling at retail.
(3) Returnable containers sold empty for refilling.

(d) Application of general rule.
(1) Nonreturnable wrapping material and empty containers. To qualify for this exemption, nonreturnable wrapping materials and empty containers must be used by the purchaser in the following way:
(A) The purchaser must add contents to the containers purchased; and
(B) The purchaser must sell the contents added.
. . .

(e) Definitions.
(1) Returnable containers. As used in this regulation [45 IAC 2.2], the term returnable container means containers customarily returned by the buyer of the contents for reuse as containers.
(2) Nonreturnable containers. As used in this regulation [45 IAC 2.2], the term "nonreturnable containers" means all containers which are not returnable containers.

As mentioned, Taxpayer manufactures parts used in the automotive industry. Taxpayer's customers order a specific number of parts that are predetermined by the customer during the ordering process. Parts are not interchangeable between customers. The parts are manufactured and packaged directly into nonreturnable packaging. The packaging consists of a base pallet, cardboard box, cardboard lid, and corner posts. Some orders also require internal cardboard walls to secure the parts. All of this packaging arrives at Taxpayer's facility assembled and ready for instant use as the parts are completed on the manufacturing line and immediately packaged. Customers do not return any portion of the packaging to Taxpayer.

Taxpayer's shipping containers meet the requirements under IC § 6-2.5-5-9(d) and 45 IAC 2.2-5-16 as nonreturnable packaging. Taxpayer purchases the cardboard boxes and inserts in order to sell the parts purchased by customers. Taxpayer manufactures the parts, places those parts in the boxes, and ships the parts to the customer. The parts are then used by the customer to build a vehicle. The shipping containers are nonreturnable packaging and are exempt.

The Department notes that Taxpayer's original protest included information regarding sixteen purchases of nonreturnable packaging; however, Taxpayer only provided receipts for three purchases of packaging. Taxpayer's representative confirmed that only the three purchases for which receipts were provided are being protested. Two invoices were included in Stratum 3 dated December 2, 2019 (in the amount of $4,167.00) and December 11, 2018 (in the amount of $3,999.86 - packaging purchase price less an $8.95 fuel surcharge) and Stratum 4 dated March 27, 2018 (in the amount $6,588.00). Because Taxpayer is only protesting three specific purchases, only the three specified purchases are tax exempt.

Taxpayer also argues that certain manufacturing equipment and machinery are exempt under 45 IAC 2.2-5-8(c) because the items are directly used in the manufacturing process. Specifically, Taxpayer argues that "banding steel" and four conveyor belts should be exempt.

Taxpayer's manufacturing process includes making steel plates which are later attached to specific automobiles. As part of this process, Taxpayer purchases large rolls of raw steel. These steel rolls are inserted into the stamping machine. While the stamping machine is stopped, the banding steel holds the rolls of raw steel together. Without the banding steel, the raw steel is unusable.

It is not clear from the audit report how the Department determined banding steel should be taxed. It appears the Department classified it as "non-manufacturing supplies and equipment." However, part of the integrated process of manufacturing involves stamping the plates from steel rolls. Without the banding steel, Taxpayer cannot use

the raw steel materials and cannot complete the manufacturing process. The banding steel is exempt because it is part of the integrated manufacturing process.

Finally, Taxpayer argues that four conveyor belts used for scrap removal should be considered tax exempt because the belts "are part of a distinct and separate manufacturing process." During the manufacturing process of the steel plates, the stamping machine stamps out a part during the "primary" process. A portion of the raw material is cut away and considered scrap. The scrap metal travels down a separate system of conveyor belts, in shaker pans, where the scrap is then packaged and later sold to another vendor for recycling. Taxpayer believes the conveyor belts that transport the metal scrap should be exempt because recycling the scrap material constitutes a separate manufacturing process. The Department determined that scrap removal was not part of the production process, thus, the conveyor belts were taxable.

The Department recognizes the scrap removal system is a necessary part of Taxpayer's manufacturing process. Yet, the removal does not satisfy the "double direct" test delineated in IC § 6-2.5-5-3(b), which requires the exempt property to be directly used in the direct production of goods. The scrap removal conveyor system is not part of direct production but rather is a component of post-production. Once a part is punched out, the scrap is no longer part of the production process. Because the production of the main part (i.e., the primary production process) has ended, the conveyor belts are not part of direct production.

Further, 45 IAC 2.2-5-10(k) provides:

> (k) Definitions. Processing or refining is defined as the performance by a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change. Operations such as distilling, brewing, pasteurizing, electroplating, galvanizing, anodizing, impregnating, cooking, heat treating, and slaughtering of animals for meal or meal products are illustrative of the types of operations which constitute processing or refining, although any operation which has such a result may be processing or refining. **A processed or refined end product, however, must be substantially different from the component materials used**. (**Emphasis added**.)

The Department does not dispute that Taxpayer sells the scrap metal, but the scrap is not a product **manufactured** by Taxpayer. The scrap is a by-product of the manufacturing process that Taxpayer later sells to a recycler. The scrap is not an item that is manufactured by the transformation of component raw materials into a distinct product. Taxpayer does not change or cut down the scrap into a different form. Consequently, the conveyor belts used to transport the scrap metal do not qualify for an exemption.

In summary, Taxpayer's protest is sustained as it relates to the storage containers, packaging materials, and banding steel as these items are tax exempt. Taxpayer has not met the burden of IC § 6-8.1-5-1(c) of proving the proposed assessment is wrong related to the conveyor belts.

FINDING

Taxpayer's protest is partially sustained and partially denied.

March 10, 2023

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An html version of this document.