

Letter of Findings: 04-20221058
Sales 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 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 purchases should not have been included in a statistical sampling because purchases were either tax exempt because the items were directly used in manufacturing or because the Business had already self-assessed and remitted use tax.

ISSUE

I. Sales and Use Tax - Imposition.

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 § 6-8.1-5-1; *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 462 (Ind. 2012); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Rhoads v. Indiana Dep't of State Revenue*, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); *USAir, Inc. v. Indiana Dep't of State Revenue*, 623 N.E.2d 466 (Ind. Tax Ct. 1993); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399 (Ind. Tax Ct. 1991); *Indiana Department of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983); *Monarch Steel Co. v. State Bd. Of Tax Comm'rs*, 611 N.E.2d 708 (Ind. T.C. 1993); [45 IAC 2.2-2-1](#); [45 IAC 2.2-5-8](#).

Taxpayer protests the assessment of use tax on tangible personal property.

STATEMENT OF FACTS

Taxpayer is an Indiana subsidiary of an out-of-state manufacturing company. Taxpayer was subject to an audit related to tax years 2018, 2019, and 2020. During the audit process, Taxpayer and the Indiana Department of Revenue ("Department") agreed on a sampling methodology using tax year 2020 as the base. The resulting 2020 percentage of error rate was then projected to purchases made in tax years 2018 and 2019. As a result of the audit, the Department issued an assessment for additional tax related to each of the three tax years totaling approximately \$16,000. Taxpayer protested the assessments. An administrative hearing was held. This Letter of Findings results. Additional facts will be provided as necessary.

I. Sales and Use Tax - Imposition.

DISCUSSION

The Department and Taxpayer agreed on a sampling methodology for the audit related to general expense purchases and further agreed that the error rate calculated from the 2020 purchase records would be projected to purchases made in tax years 2018 and 2019 to calculate any assessment due. The audit resulted in an assessment of additional use tax due by Taxpayer. A significant portion of the audit adjustments were assessed use tax by the Department pursuant to [45 IAC 2.2-5-8](#).

In its protest submission, Taxpayer argued that fourteen specific items related to its manufacturing processes should not have been included in the numerator of the calculation of the error rate because those items were tax-exempt and seven other items should not have been included because use tax was already self-assessed.

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 *Rhoads 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 Dep't 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 Dep't 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](#).

Taxpayer argues that fourteen items should have been excluded from the numerator of the error rate calculations because the items are directly used in the manufacturing process, thus making those items tax exempt. The relevant statute is IC § 6-2.5-5-3, which 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.**)

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 Department 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.*

Taxpayer's manufacturing plant has multiple production lines producing different products and/or components. Each assembly line uses its own equipment to produce those specified parts or components, then assembles the product being manufactured on that particular line, and finally packages the product for shipment. Products are only shipped to suppliers; Taxpayer does not ship "direct to consumers."

Taxpayer argues that certain items are tax exempt because these parts are directly involved in the manufacturing process. In support, Taxpayer provided purchase invoices, photographs, and an explanation of the manufacturing processes. Items Taxpayer argued are exempt are listed below, referenced by the item numbers provided by Taxpayer in the protest materials.

- Item 31 - A twin or tri-spindle drill head mounted on the assembly line that drills holes in the threshold.

- Item 81 - A vibrating bowl that cleans and polishes retainers (metal washers) at the beginning of the manufacturing process. Without this machine and manufacturing step, the retainers are not usable parts.
- Item 65 - Filters and oil kits used on industrial air compressors that provide 110 PSI air to the assembly line. All other items listed on the invoice (other than the labor charge) are parts or lubricants that go into the air compressors.
- Item 66 - Additional parts and two liters of coolant for the industrial air compressors mentioned above.
- Item 43 - A generator, suction cups, and tubing that attaches to a robot used on the manufacturing line. The robot performs drilling steps on the assembly line. The generator provides air/suction to the machine so the robot can pick up the necessary part with the suction cup and move the part to the correct placement. Once the part is in the correct position, the drills are activated.
- Item 70 - A laser sensor that assists in the application of "rubber seals" in the manufacturing process.
- Item 28 - A robot with "grippers" that moves parts on a conveyor belt and assists in cutting items down to the correct size. This robot is used in the middle of the manufacturing process.
- Item 153 - A Surface Go tablet that is integrated into the machine that controls a saw and communicates regarding positioning of parts. The tablet scans a barcode that moves the part to the correct position on the table for cutting.
- Item 71 - A second laser sensor on the same machine as Item 70.
- Item 72 - A laser sensor that assists with part placement and accompanying cable that attaches the laser to the manufacturing equipment.
- Item 46 - A "vacuum picker" that picks up a retainer, places the retainer in the correct position, and holds the retainer as it is attached during the manufacturing process.

After a review of the Department's audit report as well as information provided by Taxpayer for the above eleven items, the Department agrees the items used in the manufacturing processes are tax exempt as manufacturing equipment. Thus, these items should be removed from the numerator of the Department's calculation when determining the error rate for tax year 2020. The Department notes that the receipt provided for Item 153 shows a total purchase price of \$2,912.72, and this is the same amount that was included in the Department's audit working papers. However, the purchase price for this item was \$2,749.99, a difference of \$162.73. The \$162.73 is the total for two separately stated shipping charges, and the shipping charges are not tax exempt. The tax-exempt portion for the statistical sampling is only the purchase price of the actual equipment used in the manufacturing process or \$2,749.99. These amounts will be updated accordingly as the Department recalculates the appropriate numerator and error rate.

Under [45 IAC 2.2-5-8\(d\)](#), "[d]irect 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." (**Emphasis added.**) Under subsection (d), Example 1 discusses the production of pharmaceutical items where the manufacturing process begins with the weighing and measuring of ingredients, continues with combining and treating those ingredients, and ends with packaging the items. All weighing and measuring equipment and all equipment used as an essential and integral part of the subsequent manufacturing steps, through packaging, qualify for an exemption. Further clarification is provided by *Monarch Steel Co. v. State Bd. Of Tax Comm'rs*, 611 N.E.2d 708, 714 (Ind. T.C. 1993) where the tax court explained processing is concerned with the alteration of an article's state or form while packaging is concerned with transit and storage. "Processing refers to the preparation of a final saleable product, while packaging presumes a final saleable product already exists, and all that remains is to prepare it for shipping or storage." *Id.*

Taxpayer explained that Item 73 is a laser sensor that assists in applying protective film to products. The sensor controls the machine and indicates when to apply the protective film and when to cut the film. The application of the film is the last step in the manufacturing process and is applied to the "completed" product. Taxpayer further explained that the film is applied at the customer's request. The film serves to protect the parts during the boxing and shipping processes.

Considering this explanation, Taxpayer's integrated production process is not complete until Taxpayer applies and film to the completed product as the last step of the manufacturing process. It should be noted that the laser is not exempt because the laser applies shipping materials. Rather, Item 73 is exempt because it is used within a continuous, integrated process which produces a particular article and acts within, and not outside of, Taxpayer's integrated production process. The article being produced is a product where the film is required to be applied per the customer's specifications. Thus, Item 73 is also exempt.

Additionally, Taxpayer noted Items 29 and 30 should be removed from the audit sampling because the two purchased items were later returned. Taxpayer provided copies of the original purchase receipts as well as a

credit receipt from the same vendor for the returned products. These two purchases should be removed from both the numerator and denominator when calculating a new error rate.

Taxpayer also argues that several items were incorrectly included in the numerator of the statistical sampling because Taxpayer previously self-assessed use tax on those purchases. Taxpayer provided receipts and details related to use tax that was self-assessed and paid during tax year 2020. Taxpayer's documentation shows that Taxpayer self-assessed use tax on certain purchases and remitted the correct amount of use tax during tax year 2020. Items for which self-assessed use tax was already paid and remitted should have been excluded from the statistical sampling. Specific items, as referenced by Taxpayer, are Item 56, Item 139, Item 140, Item 141, Item 144, Item, 146, Item 147, and Item 148.

After review, Taxpayer has shown the Department's assessment was incorrect under IC § 6-8.1-5-1(c). Documentation provided shows certain items included in the statistical sampling should have been excluded from the numerator of the Department's error rate calculations because the items are either tax exempt because they are directly used in manufacturing or were previously assessed use tax. The two returned items will be excluded from the entire calculations since those purchases were undone. The Department will remove the exempt items discussed in this Letter of Findings from the numerator of the statistical sampling calculation, remove the two returned items from the sample population completely, adjust the purchase price for Item 153 in the statistical sampling, and remove the items that were self-assessed use tax from the statistical sampling. The Department will then calculate a new error rate for tax year 2020. The 2020 error rate can then be projected to tax years 2018 and 2019. Any new calculations made by the Department will include a recalculation of base tax due, if any, as well as a recalculation of interest, to reflect a new assessment for each tax year less any applicable credits Taxpayer has on its account.

FINDING

Taxpayer's protest is sustained.

March 7, 2023

Posted: 05/24/2023 by Legislative Services Agency
An [html](#) version of this document.