INDIANA DEPARTMENT OF STATE REVENUE

Revenue Ruling #2002-09ST

June 13, 2002

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ISSUES

Sales/Use Tax and Gross Income Tax - Restructuring

Authority: IC 6-2.5-5-3, IC 6-2.5-5-4, IC 6-2.5-5-5.1, IC 6-2.5-5-30, IC 6-2.5-5-6, Mid-America Energy Resources, Inc. v. Indiana Department of State Revenue, Indianapolis Fruit Co. v. Department of State Revenue, Rule 45 IAC 2.2.5-10, IC 6-2.5-4-2, IC 6-2.1-2-3, IC 6-2.1-2-4, IC 6-2.1-2-1, Rule 45 IAC 1.1-1-23, IC 6-2.1-5-5, IC 6-2.1-4-6, Internal Revenue Code Section 1504

The taxpayer requests the Department to rule, if the taxpayer restructures to form A Co as described herein, whether or not:

1. The taxpayer will continue to be entitled to the sales and use tax industrial exemptions found in IC 6-2.5-5-3, IC 6-2.5-5-4, IC 6-2.5-5-5.1 and IC 6-2.5-5-30, also including, without limitation the exemption provided by IC 6-2.5-5-6 for the raw materials the taxpayer purchases to make orthopedic implants;

2. A Co will be treated as an industrial processor for sales and use tax purposes and will be entitled to the industrial exemptions found in IC 6-2.5-5-3, IC 6-2.5-5-4, IC 6-2.5-5-5.1, IC 6-2.5-5-30 and IC 6-2.5-5-6;

3. A Co will be treated as an industrial processor for Indiana gross income tax purposes and its receipts will be subject to such tax at the low rate; and

4. A Co will qualify for inclusion in a consolidated gross income tax return with the taxpayer, and the taxpayer and A Co will be entitled to deduct or eliminate intercompany transactions between each other and with other members of the taxpayer's affiliated group by the filing of a consolidated return.

STATEMENT OF FACTS

The taxpayer is headquartered in Indiana and is incorporated under the laws of Delaware. The taxpayer is authorized to do business in Indiana and is a wholly-owned subsidiary of a holding company.

The taxpayer has manufacturing facilities at various locations in the United States and overseas, including Indiana. The Indiana plant manufactures certain orthopedic reconstructive implants. The orthopedic reconstructive implants are manufactured through a continuous series of production operations, which the company calls "production cells." All production cells for the implants are controlled by federal Food and Drug Administration ("FDA") regulations and industry standards on the manufacture and production of implantable orthopedic devices.

Currently, the taxpayer purchases large quantities of raw metals, such as stainless steel, titanium, chrome, etc., which are then melted, cut and formed into the basic shape of the implant. Throughout this part of the production process, a finer cut and more detailed shape is achieved. Following the cutting and shaping of an implant, the implant is run through polishing belts and wheels to remove excess metal particles and produce a smooth, polished metal surface.

The implants are then etched with an identification number. This production cell is mandated by United States FDA regulations and foreign government agencies to provide traceability on an implant.

Thereafter, the implant is immersed in a solution to remove foreign materials. This passivation process is intended to improve the corrosion resistance of the implants and remove objectionable surface contaminants such as microscopic bioburden and bacteria.

The implant is then rinsed and dried, and inspected, packaged, shrink-wrapped and sent out for further sterilization before being shipped to customers in the United States and abroad.

For various business reasons, the taxpayer intends to form a company ("A Co") and contribute to A Co its Indiana manufacturing facility. A Co will be a Delaware corporation, qualified to do business in Indiana. The taxpayer will own 75% of the voting stock of A Co. A separate wholly-owned (100%) subsidiary of the taxpayer ("B Co") (a foreign corporation) will hold the remaining 25% of A Co's voting stock.

The taxpayer will then contract with A Co to perform those implant production cells which consist of melting, shaping, forming and polishing of the implant. The taxpayer will continue to purchase all raw materials incorporated into the orthopedic implant. The raw materials will be directly delivered from the suppliers to a warehouse located in the

Indiana plant owned by A Co. The taxpayer will retain title to the raw materials and work-in-process as they are processed by A Co.

After A Co has completed its processing, the partially completed implants will be transferred to the taxpayer which will perform the etching and chemical passivation through to final packaging, as described above. The taxpayer will lease from A Co the space and equipment at the Indiana plant necessary to perform its portion of the manufacturing process.

DISCUSSION

Issue 1– Whether or not the taxpayer, after the corporate restructuring, will be engaged in manufacturing and production and will entitled to the industrial exemptions under IC 6-2.5-5-3, IC 6-2.5-5-4, IC 6-2.5-5-5.1, IC 6-2.5-5-30 and IC 6-2.5-5-6.

Currently, the taxpayer qualifies for all of the industrial exemptions. After the restructuring described above, the taxpayer will continue to qualify for the industrial exemptions because the taxpayer remains engaged in production and manufacturing of tangible personal property, even though it has contracted with A Co to perform part of the implant manufacturing process.

The activities that the taxpayer will continue to perform after the restructuring constitute manufacturing and qualify the taxpayer for the industrial exemptions. The etching, chemical passivation, inspecting, packaging and shrink-wrapping of the orthopedic implant are all steps that are needed – indeed, are legally required – to produce a marketable implant. As the Tax Court has recognized, "production is 'broadly defined' and focuses on the creation of a marketable good." *Mid-America Energy Resources, Inc. v. Indiana Dep't of State Revenue,* 681 N.E.2d 259, 262 (Ind. Tax Ct. 1997) where the court found that the chemical treatment and chilling of water constituted production; *see also Indianapolis Fruit Co. v. Department of State Revenue*, 691 N.E.2d 1329 (Ind. Tax Ct. 1998), where the chemical treatment of bananas was found to constitute production.

The implant preparation activities which the taxpayer will continue to perform after the restructuring are required to produce a marketable implant and clearly result in important changes in the partially finished implants that are transferred to the taxpayer from A Co, i.e. resistance to corrosion, traceability and sterility.

In short, after the restructuring, the taxpayer will be entitled to an exemption from sales and use tax for its raw material purchases, its machinery and equipment purchases and its purchases of other tangible personal property under IC 6-2.5-5-3; IC 6-2.5-5-4; IC 6-2.5-5-5.1; IC 6-2.5-5-6 and IC 6-2.5-5-30 because it will continue to be engaged in production and manufacturing.

Issue 2 – Whether or not A Co is engaged in industrial processing for Indiana sales and use tax purposes and may claim the industrial sales and use tax exemptions.

The industrial exemptions extend to industrial processors. 45 IAC 2.2-5-10. An industrial processor is a person who acquires tangible personal property owned by another person, provides industrial processing or servicing and transfers the property back to the owner to be sold by that owner in the same form or as a part of other tangible personal property produced by that owner in his business of manufacturing. IC 6-2.5-4-2(c); 45 IAC 2.2-5-10(a)(1)-(3).

In this case, A Co will qualify as an industrial processor because A Co acquires raw materials owned by the taxpayer, provides industrial processing (melting, forming and shaping) and transfers the work in process back to the taxpayer to be further manufactured by the taxpayer into a finished orthopedic implant, which is then sold. As an industrial processor, A Co will be entitled to the sales and use tax exemptions provided by IC 6-2.5-5-3; -4; -5.1; -6 and –30.

Issue 3 – Whether or not A Co's gross receipts are subject to the low rate (0.3%).

IC 6-2.1-2-3 provides that gross income from transactions listed in IC 6-2.1-2-4 are subject to a tax rate of 0.3% (the "low rate"). Among the transactions listed in IC 6-2.1-2-4 that are subject to the low rate are wholesale sales. Wholesale sales include, *inter alia,* receipts from industrial processing or servicing if the property is owned and produced for sale by the business for whom the servicing or processing is performed. IC 6-2.1-2-1(c)(1)(D); 45 IAC 1.1-1-23(b).

In this case, A Co by contract will function as an industrial processor for the implants owned by the taxpayer. The implants are owned and produced for sale by the taxpayer. In short, any gross receipts generated by A Co are receipts from industrial processing, are wholesale sales, and are subject to the low rate of gross income tax.

Issue 4 – Whether or not the taxpayer and A Co qualify to file a consolidated gross income tax return and may deduct or eliminate from that return gross receipts from intercompany transactions among members of the affiliated group.

IC 6-2.1-5-5(b) provides that corporate members of an affiliated group that are incorporated or authorized to do business in the state may file a consolidated gross income tax return. IC 6-2.1-4-6 provides that an affiliated group of corporations filing a consolidated gross income tax return is entitled to a deduction from the gross income reported on the consolidated return in the amount of gross income received from transactions between members of the group that are incorporated in or authorized to do business in Indiana. IC 6-2.1-5-5(a) provides that corporations are "affiliated" if at least 80% of the voting stock of one corporation is owned by the other corporation.

In this case, both the taxpayer and A Co will be authorized to do business in Indiana. The taxpayer will directly hold 75% of the voting stock of A Co. The remaining 25% of A Co's voting stock will be held by B Co, a wholly-owned (100%) subsidiary of the taxpayer. For gross income tax purposes, through direct and indirect ownership, the

taxpayer holds 100% of the voting power of A Co and the taxpayer and A Co should be permitted to file a consolidated gross income tax return.

This conclusion is supported by how the 80% stock ownership test is calculated to determine affiliation for federal income tax purposes. The 80% stock ownership test is met in a chain of corporations if the common parent corporation holds at least 80% of the stock of at least one includible corporation in that chain and at least 80% of the stock of the other includible corporations in the chain is held directly by one or more of the other includible corporations in the chain. See IRC Section 1504(a).

As explained, the taxpayer and A Co will not be affiliated for federal income tax purposes because B Co, a foreign corporation, is not an includible corporation for federal income tax purposes. However, but for B Co's status as a foreign corporation, the 80% stock ownership test would otherwise be met for federal purposes and the taxpayer and A Co could file a consolidated federal return.

By contrast, the Indiana gross income tax law provides that a foreign corporation, such as B Co, is includible in a consolidated return if it is qualified to do business in Indiana. In this case, B Co will be qualified to do business in Indiana. Therefore, B Co is includible in the taxpayer's consolidated gross tax return and the 80% voting stock test of IC 6-2.1-5-5(a) is satisfied not only with respect to B Co but also with respect to A Co. As a result, the taxpayer, B Co and A Co may file a consolidated gross income tax return and may deduct the gross income received from transactions between them as members of the consolidated group.

RULINGS

The Department rules that:

Issue 1 – The taxpayer will be engaged in manufacturing and production and will continue to be entitled to the sales and use tax industrial exemptions pursuant to IC 6-2.5-5-3, IC 6-2.5-5-4, IC 6-2.5-5-5.1 and IC 6-2.5-5-30, including without limitation, IC 6-2.5-5-6 for the raw materials the taxpayer purchases to make orthopedic implants;

Issue 2 – A Co will be treated as an industrial processor for sales and use tax purposes and will be entitled to the industrial exemptions provided by IC 6-2.5-5-3, IC 6-2.5-5-4, IC 6-2.5-5-5.1, IC 6-2.5-5-30 and IC 6-2.5-5-6;

Issue 3 – A Co will be treated as an industrial processor for Indiana gross income tax purposes and its receipts will be subject to such tax at the low rate; and

Issue 4 – A Co will qualify for inclusion in a consolidated gross income tax return with the taxpayer and the taxpayer and A Co will be able to deduct or eliminate intercompany transactions between each other and with other members of the affiliated group by the filing of such a consolidated return.

CAVEAT

This ruling is issued to the taxpayer requesting it on the assumption that the taxpayer's facts and circumstances, as stated herein, are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting this ruling may not rely on it. However, other taxpayers with substantially identical factual situations may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material respect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that subsequent to the publication of this ruling, changes in statute, a regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.

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