Indiana Manufacturers Association
IMA Tax Talk
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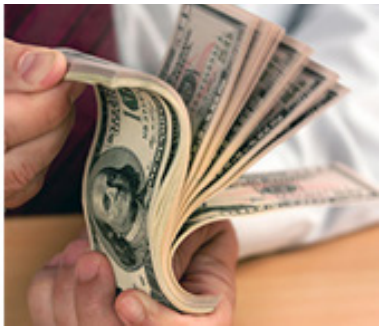
July 2014



# Chemicals, Computers, Clear Wrap, Construction Material and Catwalks – Indiana Department of Revenue Rulings on a Cacophy of Sales and Use Tax Protests in 2014

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In the first half of 2014, the Indiana Department of Revenue issued several Letters of Finding ruling on manufacturers' protests of sales and use tax assessments. Following is a summary of some of those decisions.

**Quality control software and related hardware exempt; unitary transaction of software and related services subject to tax.** A manufacturer of plastics components protested the assessment of use tax on its computer hardware and software purchases. In LOF No. 04-20140027 (posted May 28, 2014), Taxpayer argued that the purchases were exempt under IC 6-2.5-5-3 as machinery, tools or equipment acquired for direct use in direct production of other tangible personal property.

The Department explained that exemptions are "highly fact sensitive." (quotation omitted.) To claim an exemption, a taxpayer must first show that it produces tangible personal property, because "without production there can be no exemption." (*quoting Indianapolis Fruit Company v. Department of State Revenue*, 691 N.E.2d 1379, 1384 (Ind. Tax Ct. 1998.) To be considered directly used in direct production, the property must be "an essential and integral part of an integrated process." A taxpayer must identify the scope of production; it "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." (quoting 45 IAC 2.2-5-8(d).) Furthermore, the Department noted that property "may be essential and integral to an integrated production process without actually transforming the composition of the tangible personal property being produced." (*citing Indiana Department of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520, 524 (Ind. 1983).) Property may not be essential and integral to an integrated production process even though it may be considered essential to the conduct of the manufacturing business. (quoting 45 IAC 2.2-5-8(g).)

With this background, the Department allowed a partial exemption for quality control software "used throughout the production cycle to ensure that a marketable product is created." But an exemption was denied for software used for non-operational activities such as monitoring and reporting production, viewing documents and printing labels. Hardware directly used by the exempt software was also partially exempt. (citing 45 IAC 2.2-5-8(c) Example (7).)

In LOF No. 04-20130271 (posted May 28, 2014), Taxpayer manufactured a variety of products from corn, and it claimed the Department incorrectly assessed tax regarding purchases from various "service contractors." One contractor sold scales, and its invoice showed a unitary charge for "programming, software and installation" on computers for a new scale, including programming "to follow date flow chart as outlined." This latter statement suggested that the contractor provided taxable "prewritten" or "canned" software. Even if Taxpayer paid for specific modifications or enhancements, the contractor's invoice did not provide a separate charge as required by IC 6-2.5-1-24(4). And Taxpayer failed to show the charges were for nontaxable installation services, which also must be separately stated on the invoice under IC 6-2.5-1-5(b)(6). The Department observed, "[S]ince Taxpayer's invoice was for one unitary amount, any amount included in the charge for installation or other services would be subject to tax."

**Shipping labels necessary for business but not essential to production.** Also in LOF No. 04-20140027, the Department found that shipping labels were taxable. The labels were used for tracking. Customers required them. While they may have been essential to Taxpayer's business, the labels and ink used to print them were not shown to be essential and integral to the integrated production process. The Department reached the same conclusion in LOF No. 04-20130325 (posted Feb. 26, 2016), where the manufacturer of "shelf-stable" meals protested the assessment of tax for labels and label software. Taxpayer argued that the labels for "meals-ready-to-eat" (MREs) sold to the government ensured the safety and delivery of its products. The labels contained electronically stored data that could be

# Sales and Use Tax Protests in 2014 Continued

read from several meters away, preventing the need for a physical inventory. Nevertheless, the Department concluded that the labels were not incorporated into the MREs. They were applied after production had ended and were therefore taxable.

**Sodium chloride, parts for water wells, and concrete foundation for nitrogen storage tank were used outside of production; "purge materials" used for cleaning during production were exempt.** Taxpayer in LOF No. 04-20130604 (posted June 25, 2014) manufactured sanitation chemicals and equipment used by food processors. Taxpayer protested the assessment of use tax on purchases of sodium chloride and parts for its water wells. According to Taxpayer, the sodium chloride was used to "regenerate" the softener process, which in turn was part of the production process. The Department was not convinced, asserting that Taxpayer failed to satisfactorily explain the difference between "regeneration" and "cleaning." The softener is out of production when the action (however it's described) occurs. The sodium chloride was not shown to be directly used in direct production. Parts for water wells also were taxable. The Department explained that the water is "transported, not transformed" and that the "drawing up and filtering of water is a preproduction activity since it does not directly affect the manufacturing process."

Taxpayer in LOF No. 04-20130271 (discussed above) protested the use tax assessment against the concrete foundation for a nitrogen storage tank foundation. According to the Department, only property that has an "immediate effect on and is essential to the direct production of a marketable good" is exempt. Taxpayer's tanks were used to store and circulate nitrogen into the manufacturing process. Nitrogen was required to make certain of alcohol products. The Department admitted that foundations necessary to support production equipment have been found exempt. This tank was used only for pre-production storage of a raw material. Therefore, the tank's foundation was subject to tax.

The Department agreed that a Taxpayer's purchases of "purge materials" were exempt in LOF No. 04-20130524 (posted June 25, 2014). The Department relied on the Tax Court's decision in *Guardian Automotive Trim, Inc. v. Indiana Department of State Revenue*, 811 N.E.2d 979 (Ind. Tax Ct. 2004), where the Court held that the process for cleaning masks used to make molded plastic parts was integral to the manufacturing of automotive trim parts and therefore the mask processing equipment was exempt. Here, Taxpayer demonstrated that its purge materials served the same function and were exempt under IC 6-2.5-5-3 and 6-2.5-5-5.1.

**"Everything is necessary for production" was not a persuasive argument.** In LOF No. 04-20120664 (posted May 28, 2014), Taxpayer was a manufacturer of thermostat molding compounds and challenged the assessments of various items. The Department agreed that gloves used to protect employees from injury and to prevent contamination of its products were exempt. This was Taxpayer's lone victory among the items protested. It largely failed to present evidence and arguments regarding other disputed items, including: (a) forklift (photographs showed exempt and non-exempt use and Taxpayer failed to document the split); (b) floor coating materials (the floor did not have an "immediate effect" on production); (c) warehouse racking (no evidence it stored work-in-process); (d) air compressor parts and oil (no evidence as to how the compressors were used in production); (e) cooling tower (no evidence showing how tower was connected to production); (f) molds (no explanation or documentation showing the need for their use in inspection or testing); (g) labels (not part of the "finished goods" but, rather, were the "ancillary means by which Taxpayer's finished product finds its way to the ultimate customer"); and (h) wrapping / packaging materials (but for Taxpayer's "say-so," no evidence showing how allegedly returnable packages were billed or how pallets and wrapping materials were used). The Department refused to waive the 10% penalty, explaining: "Taxpayer has not provided any rationale for not remitting use tax on the contested items other than basically everything it purchases is necessary for its production process."

**Steel drums, bubble wrap did not qualify as exempt nonreturnable containers or wrapping materials; clear wrap qualified for exemption; no evidence that packaging and wrapping equipment was "directly used" in "direct production."** Taxpayer produced chemicals used by other manufacturers. The Department in LOF No. 04-20120591 (posted March 26, 2014) assessed use tax on steel drums purchased to hold Taxpayer's products for shipping to its customers. Taxpayer claimed the drums were exempt under IC 6-2.5-5-9(d) as nonreturnable packages used to sell the chemicals. Taxpayer argued that customers returned only a small number of drums and that federal law and regulations prohibited customers from returning the drums. Taxpayer did not provide copies of the cited federal provisions. While it did produce a schedule showing that some of the drums were not returned, that was insufficient to overcome the Department's finding that the drums were customarily returnable.

In LOF No. 04-20130516 (posted April 30, 2014), Taxpayer manufactured, sold and distributed prescription pharmaceuticals. To be exempt, the Department's regulation required that the purchaser (a) add contents to the containers purchased and (b) sell the contents added. (citing 45 IAC 2.2-5-16(d)(1).) Taxpayer was able to show that clear wrap, pallet slipsheets, stretch film and hand wrap were exempt as "nonreturnable wrapping materials" used to transport the pharmaceuticals to customers. However, "bubble wrap" was taxable because Taxpayer failed to show that it functioned as an "enclosure" or "container."

Taxpayer, a shipping and wholesale company which pack-

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# Sales and Use Tax Protests in 2014 Conclusion

aged and delivered out-of-state companies' products, in LOF No. 04-20130527 (posted May 28, 2014) failed to produce evidence showing that its equipment was "directly used" in the "direct production" of the products it sent to customers. Moreover, evidence indicated that production of the products occurred someplace else. Consequently, the Department determined that Taxpayer's purchases of wrapping equipment, packaging equipment and related parts were subject to tax.

**No tax due for items acquired as part of lump sum contracts; computer software was not "construction material"; tax owed on materials sold under time and materials contract.** The Taxpayer in LOF No. 04-20130485 (posted April 30, 2014) correctly argued that it did not owe sales or use tax on items purchased pursuant to lump-sum contracts for improvements to its realty. A contractor "is responsible and liable for the payments of sales tax" in lump sum contracts, i.e. a "contract in which all of [the] charges are quoted as a single price." (quoting Sales Tax Information Bulletin 60 (July 2006).) A lump sum contractor pays sales tax when it buys materials needed to fulfill its contracts unless the customer issues it an exemption certificate. In this case, Taxpayer submitted proof that the disputed transactions were lump sum contracts. It was not required to pay tax on the transactions.

The Taxpayer in LOF No. 04-20130271 (discussed above) argued that tax relating to unitary charges included in an invoice for software and related services were the contractor's responsibility. But the computer software was not "construction material" that became part of an "improvement to realty." Accordingly, the Department refused "to extend the treatment allowed for the conversion of construction materials under a lump sum contract to Taxpayer's transaction." The unitary transaction was taxable.

With respect to use tax assessed on floor coating materials installed pursuant to a time and materials contract ("a contract in which all the charges for labor, construction materials, and other items are stated separately"), this same Taxpayer presented evidence that the contractor had paid sales tax when the contractor had acquired the materials. This fact, if true, did not help Taxpayer. While the contractor may have a refund claim regarding any improperly paid tax, Taxpayer's "obligation to pay sales and use tax arose at the time of Taxpayer's purchase of the items."

Taxpayer also owed tax on its purchases of "alcohol loadout winch movers" and the fabrication of a "peak access catwalk." Because the invoices for both reflected a single price for all charges, Taxpayer asserted that its contractors were responsible for tax under these "lump sum" contracts. Again looking to Sales Tax Information Bulletin 60, the Department concluded that the contested items did not meet the requirements for personal property to be considered an "improvement to realty," i.e. the property must be "immovable, annexed, adapted" and become "a permanent part of the land so that it would pass with the land upon a sale." Since neither item qualified as "construction materials" that become part of the real property, Taxpayer owed tax on the unitary transactions. The Department reached the same conclusion as to Taxpayer's acquisition of an "IPA storage tank." The foundation constructed for the tank qualified as an "improvement to realty," but the Department found that it was purchased under a time and materials contract. Taxpayer owed use tax on the "materials" component of the contract – not on the labor component.

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