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This Week in State Tax (TWIST)



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Indiana: Tax court holds that parts of water system qualify for sales tax exemption; remainder requires trial for determination

The Indiana Tax Court recently ruled on cross-motions for summary judgment regarding whether a water utility's purchases of pipes, pipe accessories, and related equipment qualify for Indiana's manufacturing equipment exemption or environmental quality exemption. The taxpayer treats raw water to make it suitable for drinking and pressurizes it before delivering it through pipes and booster stations to customers. The taxpayer sought a refund of sales and use tax on more than $14.5 million in equipment purchased from 2018 through 2020. The Department of Revenue denied the refund for much of the equipment, taking the position that only the purchases of equipment used at the treatment plant qualified for exemption and that subsequent piping and equipment to deliver the water to the customer is a distribution system not eligible for the exemption.

The manufacturing equipment exemption applies to equipment acquired “for direct use in the direct production … of other tangible personal property,” with production continuing until the most marketable product emerges. The Tax Court differed from the Department and found that the taxpayer's marketed product is potable, pressurized water usable at the customer's tap, not just potable water. Given that pressure and chlorine levels drop as water moves through the system, booster stations that adjust pressure or add chlorine produce – rather than merely preserve – a finished product. Relying on Indiana Supreme Court precedent, the court held that the "first mile" of piping, from the treatment plant through the last booster station, is essential and integral to production. The taxpayer's evidence on the "last mile" of piping beyond that point was too conclusory and insufficiently detailed to support the exemption. It was sufficient though to keep the Department from prevailing in its position that those pipes are merely passive conduits. The court also reserved judgment on whether the first-mile exemption is full or partial because the record did not show how often the booster stations are used.

The environmental quality exemption covers property predominantly used and acquired to comply with environmental quality laws. The court rejected the taxpayer's view that the regulatory mandate it faces to treat the water is by itself enough to satisfy the statute. It also rejected the Department's "but for" test which would say the machinery is used predominantly to meet an environmental requirement only if it served no other purpose. In the court’s view, environmental compliance must be the leading or prevailing purpose for such purchases to qualify for exemption. The record did not show which purpose prevailed items for items such as backfill, tracer wire, and meters that were also for engineering, asset-tracking, and revenue reasons. Consequently, the court denied summary judgment to both parties on this exemption.

Following the decision on the parties’ motions, the case will continue as to the remaining issues. For more information on *Indiana American Water Co., Inc. v. Ind. Dep't of State Revenue*, please contact Dave Perry.

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