

BEFORE THE IOWA DEPARTMENT OF REVENUE
HOOVER STATE OFFICE BUILDING
DES MOINES, IOWA

IN THE MATTER OF	*	
	*	DIRECTOR'S FINAL ORDER
CNH Industrial America, LLC	*	ON APPEAL
621 State Street	*	
Racine, WI 53404	*	
	*	DIA No. 15IDR091
Sales/Use Tax	*	DOCKET No. 2015-320-1-0071

I. STATEMENT OF THE CASE

On June 13, 2013, and April 29, 2014, CNH Industrial American, LLC ("CNH" or "Protestor") filed separate claims for refund of state and local option sales and use taxes for the period January 1, 2010, through September 30, 2012. On December 10, 2014, the Iowa Department of Revenue ("Department") denied the refund claims for the items at issue here. On February 11, 2015, the Protestor filed this Protest to the denial of the refund claims. On October 16, 2015, the Department filed an answer to the Protest. Jurisdiction rests within the Department pursuant to Iowa Code sections 17A.12 and 423.37.

The Director transferred the Protest to the Department of Inspections and Appeals for initiation of a contested case. The parties scheduled a hearing for the Protest on June 16, 2016. The parties subsequently agreed to a schedule for submission of the case through dispositive motions, in lieu of a hearing. The parties submitted a stipulation of facts, cross motions for summary judgment with statements of undisputed facts and supporting memoranda, and resistances. On July 15, 2016, the parties submitted the motions without oral argument upon

filing of the resistances. On December 7, 2016, Administrative Law Judge Christie J. Scase issued a Proposed Decision that found for the Department.

On January 4, 2017, the Protestor timely filed a Notice of Appeal to the Director of Revenue. On April 25, 2017, the parties presented oral arguments on appeal before the Director of Revenue. The parties presented one issue on appeal: Whether the Protestor's property at issue is exempt from Iowa sales and use tax under Iowa Code section 423.3(47)(a)(3).

II. FINDINGS OF FACT

The Director adopts and incorporates into this decision the Findings of Fact made by the Administrative Law Judge in the Proposed Decision. Importantly, the Administrative Law Judge separated the property at issue into the categories of "component parts" and "fully operational equipment:"

The aftermarket parts and equipment subject to the refund claim include component parts such as a motor, tractor axle, rotor assembly, wheel drive assembly, cab harness, chopper drum, knife drive, driver seat, fender, inner hood, hydraulic winch, door, sensor, bushing, and couplings. (Stip. ¶¶ 8-10) CNH personnel integrated the components into prototypes of prospective products. CNH then conducted performance analysis, research, and testing, on the prototypes at its engineering centers. (Stip. ¶ 8) For example, CNH purchased aftermarket engine emission control components, which CNH personnel physically integrated into prototype combines. CNH then conducted experiments on the combines, equipped with the emission control components, to measure data such as system control performance, reliability, and fuel economy. Test results were used to determine whether the components would be incorporated into CNH products. (Clifford Aff.)

The transactions at issue also include purchase or rental of fully operational pieces of equipment manufactured by competitors that were subjected to testing as a part of the CNH research and development program. For example, CNH rented a Caterpillar loader backhoe and a John Deere combine that were used for benchmarking and testing performance of the competitor's equipment against current CNH equipment or new launch production models. (Dept. Exh. B at pp. 3, 15 & Exh. C at p. 11)

III. CONCLUSIONS OF LAW

A. Application of Iowa Code §423.3(47)(a)(3).

Iowa imposes sales tax “upon the sales price of all sales of tangible personal property, consisting of goods, wares, or merchandise, sold at retail in the state to consumers or users except as otherwise provided.” Iowa Code § 423.3(2)(1) (2012).¹ Iowa imposes a corresponding use tax upon the purchase price of tangible personal property used in this state. *Id.* § 423.5(1).

The Protestor argues the property at issue here is exempt from sales and use tax under Iowa Code section 423.3(47)(a)(3). *See also id.* § 423.6(6) (extending Iowa Code section 423.3(47) to exempt the same property from use tax). This statute provides an exemption for “[t]he sales price from the sale or rental of computers, machinery, and equipment, including replacement parts, and materials used to construct or self-construct computers, machinery, and equipment if such items are . . . [d]irectly and primarily used in research and development of new products or processes of processing.” *Id.* § 423.3(47)(a)(3).

1. Computers, machinery, and equipment, including replacement parts

As an initial matter, the exemption only applies to “computers, machinery, and equipment, including replacement parts, and materials used to construct or self-construct computers, machinery, and equipment.” *Id.* CNH argues all of the property at issue is “machinery” or “equipment.” The administrative rules provide the following definitions:

“Machinery and equipment” means machinery and equipment used by a manufacturer. Machinery is any mechanical, electrical, or electronic device designed and used to perform some function and to produce a certain effect or result. The term includes not only the basic unit of the machinery, but also any adjunct or attachment necessary for the basic unit to accomplish its intended function. The term also includes all devices used or required to control, regulate,

¹ The protestor purchased the property at issue here between January 1, 2010, and September 30, 2012. The relevant statutes did not change during this period. Unless otherwise noted, all references to the Iowa Code are to the 2012 edition.

or operate a piece of machinery, provided such devices are directly connected with or are an integral part of the machinery and are used primarily for control, regulation, or operation of machinery. Jigs, dies, tools, and other devices necessary to the operation of or used in conjunction with the operation of what would be ordinarily thought of as machinery are also considered to be “machinery.” See *Deere Manufacturing Co. v. Zeiner*, 247 Iowa 1264, 78 N.W.2d 527 (1956). Also see the definition of “replacement parts” *infra*. Machinery does not include buildings designed specifically to house or support machinery. Equipment is any tangible personal property used in an operation or activity. Nonexclusive examples of equipment are tables on which property is assembled on an assembly line and chairs used by assembly line workers.

Iowa Admin. Code r. 701–18.58(1) (2012).²

The fully operational equipment is the type of tangible personal property that was used as “machinery” or “equipment” under the rules. See *id.* Therefore, the fully operational equipment qualifies as “machinery” or “equipment” for purposes of the exemption. See *id.*

However, not all tangible personal property qualifies as “machinery” or “equipment.” See *id.* “Replacement parts” and “supplies” are separate categories of property, which the administrative rules define as follows:

“*Replacement parts.*” A “replacement part” is any machinery, equipment, or computer part which is substituted for another part that has broken, has become worn out or obsolete, or is otherwise unable to perform its intended function. “Replacement parts” are those parts which materially add to the value of industrial machinery, equipment, or computers or appreciably prolong their lives or keep them in their ordinarily efficient operating condition. Excluded from the meaning of the term “replacement parts” are supplies, the use of which is necessary if machinery is to accomplish its intended function. Drill bits, grinding wheels, punches, taps, reamers, saw blades, lubricants, coolants, sanding discs, sanding belts, and air filters are nonexclusive examples of supplies. Sales of supplies remain taxable.

Tangible personal property with an expected useful life of 12 months or more which is used in the operation of machinery, equipment, or computers is rebuttably

² The relevant administrative rules did not change during the period at issue. Unless otherwise noted, all references to the Iowa Administrative Code are to the rules as they existed on September 30, 2012.

presumed to be a “replacement part.” Tangible personal property used in the same manner with an expected useful life of less than 12 months is rebuttably presumed to be a “supply.”

Id.

The components parts are not individual pieces of “machinery” or “equipment;” rather, the component parts were integrated into the CNH prototypes. CNH used the component parts for the limited purpose of research. Once CNH completed its research with a component part, CNH scrapped, sold, or returned the component part. Due to this limited useful life in the context of research and development, the component parts are “supplies” and not “replacement parts.” *See id.* Therefore, the component parts are not “machinery,” “equipment,” or “replacement parts,” and they do not qualify for exemption under Iowa Code section 423.3(47).

Subsequent changes to Iowa Code section 423.3(47) support the determination that the component parts were not exempt machinery or equipment at the time CNH purchased them. Effective July 1, 2016, Iowa expanded Iowa Code section 423.3(47) to exempt “supplies.” 2016 Iowa Acts, 86th G.A. ch. 1007, § 8. This legislation contains a new definition of “supplies,” which includes “prototype materials.” *Id.* § 9. The Department has promulgated rules to implement this legislation, and these rules include an example of newly exempt “prototype materials:”

EXAMPLE B: Company B is a manufacturer of agricultural equipment. Company B is researching and developing a new tractor. Company B purchases materials to produce a prototype of its new tractor. The prototype tractor will be tested in various settings, including a laboratory and actual agricultural production. The materials used to produce the prototype tractor are exempt supplies directly and primarily used in research and production of new products. The sales price for the materials is exempt regardless of whether Company B sells the prototype tractor after testing, or if it scraps the prototype tractor after testing.

Iowa Admin. Code r. 701–230.17(5) (effective Nov. 16, 2016).

The 2016 legislation shows the legislature intended to classify prototype materials as “supplies.” Supplies, including prototype materials, are exempt under Iowa Code section 423.3(47)(a)(3) only after this legislation took effect. 2016 Iowa Acts, 86th G.A. ch. 1007, §§ 8–9. Prototype materials and other supplies are not machinery or equipment, and prior to the 2016 legislation they did not qualify as exempt property under Iowa Code section 423.3(47). *See id.*

CNH purchased all of the component parts at issue prior to July 1, 2016. As demonstrated in the 2016 legislation and related administrative rules, these component parts are prototype materials used to produce prototypes. *See id.*; Iowa Admin. Code r. 701–230.17(5). Accordingly, the component parts are “supplies” as recognized in the 2016 legislation, and they cannot qualify as exempt machinery or equipment. *See* Iowa Code § 423.3(47)(a)(3).

2. Directly and primarily used in research and development of new products or processes of processing

Machinery and equipment must be “[d]irectly and primarily used in research and development of new products or processes of processing” in order to qualify as exempt under Iowa Code §423.3(47)(a)(3). The administrative rules provide the following definitions:

“*Directly used.*” Property is “directly used” only if it is used to initiate, sustain, or terminate an exempt activity. In determining whether any property is “directly used,” consideration should be given to the following factors:

1. The physical proximity of the property in question to the activity in which it is used;
2. The proximity of the time of use of the property in question to the time of use of other property used before and after it in the activity involved; and
3. The active causal relationship between the use of the property in question and the activity involved. The fact that a particular piece of property may be essential to the conduct of the activity because its use is required either by law or practical necessity does not, of itself, mean that the property is directly used.

...

“Research and development” means experimental or laboratory activity which has as its ultimate goal the development of new products or processes of processing. Machinery, equipment, and computers are used “directly” in research and development only if they are used in actual experimental or laboratory activity that qualifies as research and development under this subrule.

Iowa Admin. Code r. 701–18.58(1).

As explained above, the component parts are not machinery or equipment, and they do not qualify for the exemption. The fully operational equipment is machinery or equipment, and it qualifies for the exemption only if it is “[d]irectly and primarily used in research and development of new products or processes of processing.” Iowa Code §423.3(47)(a)(3).

The fully operational equipment underwent benchmarking and testing at the CNH facilities. CNH used these test results to compare its current and developing products to its competitors’ products. The ultimate goal of this comparative testing is not to develop new products. Rather, this comparative testing merely helps CNH evaluate the performance of its equipment against the performance of competing equipment. This comparative testing lacks an active causal relationship with the development of new products. *See* Iowa Admin. Code r. 701–18.58(1). Accordingly, CNH’s comparative testing of competing products is not a direct use in developing new products.³ Therefore, the fully operational equipment is not directly and primarily used in research and development of new products or processes of processing, and the fully operational equipment is not exempt under Iowa Code § 423.3(47)(a)(3).

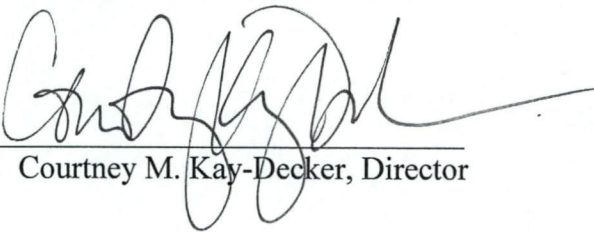
³ The federal income tax code provides a credit for increasing research activities. 26 U.S.C. § 41 (2017). As with Iowa Code section 423.3(47)(a)(3), guidance for this federal credit recognizes that merely examining an existing business component is not qualified research into a new or improved business component. Treas. Reg. § 1.41-4(c)(4) (2017).

IV. CONCLUSION

The Proposed Decision of the Administrative Law Judge is modified consistent with this Order. The Motion for Summary Judgment of the Department is granted and the Motion for Summary Judgment of CNH Industrial America is denied. The Department correctly denied the claims for refund of sales and use taxes paid because the property was not computers, machinery, and equipment, including replacement parts, directly and primarily used in research and development of new products or processes of processing, as required in Iowa Code section 423.3(47)(a)(3). The refund denial decision is affirmed.

Issued at Des Moines, Iowa this 14th day of October, 2017.

IOWA DEPARTMENT OF REVENUE

By 
Courtney M. Kay-Decker, Director

CERTIFICATE OF SERVICE

I certify that on this 14th day of October, 2017, I caused a true and correct copy of the Notice of Director's Final Order on Appeal to be delivered, or forwarded by U.S. Mail, to the following person(s):

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