

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 20896
[Redacted],)	
)	DECISION
Petitioner.)	
)	
)	
_____)	

On December 17, 2007, the Sales and Use Tax Audit Bureau (Bureau) of the Idaho State Commission (Commission) issued an amended Notice of Deficiency Determination to [Redacted] and [Redacted] (Taxpayer), asserting additional sales tax, use tax, penalty, and interest in the amount of \$14,436 for the period of August 1, 2000, through July 31, 2007. The Taxpayer’s appointed representative timely protested the deficiency on January 8, 2008. The representative requested an informal hearing, which was held on April 22, 2008.

The Commission is fully advised of the content of the audit file and the information gathered at both the hearing and in post-deficiency correspondence. For the reasons that follow, the Commission hereby upholds the Bureau’s findings.

The Taxpayer is the sole proprietor of a [Redacted] business with one location in Idaho. Its primary business is [Redacted] goods. During the audit period, the Taxpayer did not hold a seller’s permit as required by statute. A permit enables retailers to collect sales tax from customers on taxable transactions and remit that tax to the state (Idaho Code § 63-3620(a)).

The representative raises two issues in the protest. First, the representative objects to the auditor’s conclusion that the Taxpayer did not qualify for a sales and use tax exemption on the purchase of equipment and supplies used in a production process (Idaho Code § 63-3622D, commonly referred to as the production exemption). Second, the representative believes the

record sampling procedure, used to determine if any liability existed, was intentionally biased against the Taxpayer.

Analysis of the Legal Issue—the Production Exemption

The Idaho Sales Tax Act (Idaho Code § 63-3601 *et. seq.*), defines taxable sales transactions. It also enumerates sales and uses of equipment and other materials that are exempt from the tax.

Sale. (1) The term "sale" means any transfer of title, exchange or barter, conditional or otherwise, of tangible personal property for a consideration and shall include any similar transfer of possession found by the state tax commission to be in lieu of, or equivalent to, a transfer of title, exchange or barter.

(2) **"Sale" shall also include the following transactions** when a consideration is transferred, exchanged or bartered:

(a) Producing, **fabricating**, processing, printing, or imprinting of **tangible personal property for consumers who furnish, either directly or indirectly, the tangible personal property used in the producing, fabricating**, processing, printing, or imprinting. (Idaho Code § 63-3612, in relevant part, emphasis added.)

Accordingly, the auditor held the purchase of equipment and materials used in the Taxpayer's business subject to tax. Further, the auditor held [Redacted] labor taxable because the Taxpayer failed to collect tax on these transactions.

Based on information obtained at the informal hearing, the Commission believes the Taxpayer agrees that fabrication labor is taxable. The Taxpayer has since applied for and received a seller's permit to collect and remit tax on taxable sales. However, the representative disagrees that equipment and materials used by the Taxpayer in the [Redacted] process is subject to a sales tax on purchase or to a use tax thereafter. (Note: When a buyer is unable to pay sales tax to a vendor because the vendor is outside the jurisdiction of Idaho, or some error prevents sales tax collection, the buyer owes a use tax directly to the state based on the value of the

property. The use tax is the same rate as the sales tax (Idaho Code § 63-3621). Each state with a sales tax has a complementary use tax.)

The Taxpayer asks for the production exemption mentioned earlier. This exemption excludes tax on the sale, purchase, or use of items primarily and directly used in a production process. However, the exemption has certain qualifications.

Idaho Code § 63-3622D(b) states the production exemption is:

. . . available only to a business or separately operated segment of a business which is **primarily devoted to producing tangible personal property which that business will sell and which is intended for ultimate sale at retail within or without this state.**
(Emphasis added)

The Commission believes that the plain language of the statute, absent any interpretation, is sufficient to conclude that a business must own and sell what it produces in order to qualify for the exemption. In the case at issue, the Taxpayer does not own the goods, it only charges for [Redacted] labor that physically changes goods provided by the customer. The Taxpayer's available purchase records did not show raw material, nor did the representative argue that the Taxpayer bought raw material for resale. Significantly, when questioned by the auditor about the "cost of goods sold" entries on income tax returns, these were explained as labor, rather than as resale inventory.

The Commission believes it has provided the legal basis for its denial of the production exemption, but it herein further discusses the Taxpayer's dispute.

The representative believes that the Taxpayer does not need to own the goods that he [Redacted] in order to qualify for the exemption, despite the language of Idaho Code § 63-3622D(b). Yet, paragraph (c) of the code section at issue allows an exemption for;

... **a business, engaged in farming or mining**, whether as a subcontractor, contractor, contractee or subcontractee, when such business ... is primarily devoted to producing tangible personal property which is intended for ultimate sale at retail within or without this state, **without regard to the ownership of the product being produced.** (Idaho Code § 63-3622D(c). Emphasis added.)

Thus, the legislature allowed custom farmers and custom miners to benefit from the production exemption knowing that these businesses were working on land that they did not own, growing and harvesting products that they would not necessarily own or sell. If the representative's premise that ownership of the goods was not critical to the exemption, paragraph (c) of the statute would be unnecessary.

The Commission is not persuaded by the representative's rebuttal that paragraph (c) exists not because the legislature wanted to favor certain businesses with a tax exemption. It already exists, in his opinion. Rather, he believes the legislature wanted to leave no uncertainty regarding contract miners and farmers who, as a workforce, have made a significant contribution to Idaho's economy from its earliest days.

Relevant history of Idaho Code § 63-3622D supports the Commission's denial of the production exemption to the Taxpayer.

In 1990, Idaho Code § 63-3622D read as follows:

(1) The sale at retail, storage, use or other consumption in this state of tangible personal property which will enter into and become an ingredient or component part of tangible personal property manufactured, processed, mined, produced or fabricated for ultimate sale at retail within or without this state, and tangible personal property primarily and directly used or consumed in or during such manufacturing, processing, mining, farming, or fabricating operations by a business or segment of a business which is primarily devoted to such operation or operations, provided that the use or consumption of such tangible personal property is necessary or essential to the performance of such operation.

In 1991, however, Idaho Code § 63-3622D was amended to include the phrase, “which that business will sell:”

(b) The exemptions allowed in subsections (a)(1), (2), (3) and (4) of this section are available only to a business or separately operated segment of a business which is primarily devoted to producing tangible personal property **which that business will sell** and which is intended for ultimate sale at retail within or without this state.... (Emphasis added.)

In 1993, the legislature enacted House Bill 415, which expanded the production exemption with an amendment retroactive to 1990. This version exists today and has been cited previously in this decision. The amendment allows contract farmers and contract miners to claim the exemption regardless of who owns the farmed or mined product.

... **a business, engaged in farming or mining**, whether as a subcontractor, contractor, contractee or subcontractee, when such business ... is primarily devoted to producing tangible personal property which is intended for ultimate sale at retail within or without this state, **without regard to the ownership of the product being produced** (Idaho Code § 63-3622D(c). Emphasis added.)

The Statement of Purpose for House Bill 415 notes that the amendment was enacted to restore, rather than to enact, the production exemption available to contract miners in 1990, but was removed in 1991 by legislation that included the phrase, “which that business will sell.” Yet, the legislative change limited those who could qualify by not including others, such as general [Redacted]:

The purpose of this measure is to restore sales tax exemption to equipment and supplies used by contract miners. Prior to the passage of House Bill 415 of the 1991 legislative session, contract miners were eligible for exemption on the equipment and supplies used by them in the mining process. The measure defines mining for sales tax purposes and amends the production exemption to allow exemption for contract miners and farmers. (Statement of Purpose, RS 02715)

The Commission concludes from the history that the production exemption is available broadly to contract miners and contract farmers, but is reserved to all [Redacted] contingent on their ownership of the raw materials of production.

The Taxpayer's representative cites a 1994 Commission decision that he believes contradicts the current holding by the auditor. In that decision, the Commission allowed the production exemption to a photography store that processed film and sold prints. The representative refers to the exposed film, which the photographer did not own, as a contradiction to the holding in the instant case. However, the Commission allowed the production exemption because the photographer sold pictures that his business made from the processed film. (Idaho State Tax Commission, Decision #6540, 1994.) In the present case, the taxpayer is processing customer-owned goods but is not selling tangible personal property.

Finally, the representative draws our attention to the word "sell" in Idaho Code § 63-3622D(b) believing the qualifying language of the exemption exists only to prevent a business from benefiting from the exemption if it uses a product it manufactures for itself rather than hold it for sale to others. The Commission agrees that Idaho Code § 63-3622D is intended to prevent a business from claiming an exemption when manufacturing a product for purposes other than resale, or for furthering its production efforts, but that the restricting language exists as follows, rather than in Idaho Code § 63-3622D(b), as suggested by the Taxpayer:

(f) Without regard to the use of such property, this section does not exempt:....

(5) Machinery, equipment, tools or other property used to manufacture, fabricate, assemble or install tangible personal property which is:

(i) Not held for resale in the regular course of business; and

(ii) Owned by the manufacturer, processor, miner, farmer or fabricator; provided, however, this subsection does not prevent

exemption of machinery, equipment, tools or other property exempted from tax under subsection (a)(2) or (a)(3) of this section. (Idaho Code § 63-3622D(f), in pertinent part.)

The representative alternatively argues that if [Redacted] labor is taxable, the means of [Redacted] (e.g. equipment, supplies) should be exempt because they contribute to a taxable transaction. The plain reading of the production exemption statute addresses this:

Tangible personal property primarily and directly used or consumed in or during a manufacturing, processing, mining, farming, or fabricating operation, including, but not limited to, repair parts, lubricants, hydraulic oil, and coolants, which become a component part of such tangible personal property; provided that the use or consumption of such tangible personal property is necessary or essential to the performance of such operation (Idaho Code § 63-3622D(a)(2)).

However, the aforementioned must be read in the context of the limiting language of Idaho Code § 63-3622D(b) which, as noted earlier, stipulates that the exemption is available only to a business which is primarily devoted to producing tangible personal property which that business will sell.

Another argument raised by the representative concerned the concept of adding value to goods through the Taxpayer's labor. The Commission does not dispute that the value of raw material is enhanced by [Redacted] labor. However, there is no statutory basis for considering added value in determining if an exemption applies. The Commission will not create or grant exemptions where none exist in the statutes.

In the course of the audit field work, the Taxpayer was given erroneous advice on the production exemption by a member of the Bureau's audit staff. Recognition of this error by other auditors in the course of field work resulted in an increased liability for the Taxpayer and the ill will of the Taxpayer's representative toward the audit staff and the Commission. This ill will was expressed by the representative in several letters sent to the Tax Commissioners, the

governor, and elected representatives. In those letters, the representative accused Commission management of siding with auditors to misinterpret the sales tax act in an effort to increase state revenue.

The opinion of the public is of considerable concern to the Commission, but the Commission's mission is to administer the state's tax laws fairly. Regrettably, Commission staff will make errors that, once corrected, may require a changed opinion or a modified audit approach that will disadvantage a taxpayer. Yet, a change may be necessary to achieve fairness among similarly situated taxpayers. In the case at issue, the mistake was made during the audit field work. The Taxpayer was not harmed by the misinformation because he did not rely upon it to his detriment. All transactions under review were completed by the time he was advised incorrectly.

An auditor's work is guided, in part, by the Idaho State Tax Commission Sales Tax Audit Manual. Nowhere in that document does it suggest or require that an auditor's behavior be driven by a revenue motive. Auditors pursue their objectives based on professional standards:

Sufficient, competent, evidential documentation is to be obtained through inspection, observation, inquiries and confirmation to afford a reasonable basis for judgments and decisions regarding the areas under examination (Sales Tax Audit Manual, Section 115, General Standards, Paragraph E., April, 2008).

Analysis of the Audit Sampling Issue

The Taxpayer's representative objects to the sampling approach taken by the auditor. He believes that the auditor reviewed five years of records but chose only year 2005 to project a liability; and that the auditor chose year 2005 because it would result in the greatest benefit to the state and the greatest detriment to the Taxpayer.

According to one of the auditors, the records of the Taxpayer were severely lacking in completeness. In the absence of a sales journal that would describe the Taxpayer's complete business income and provide a basis from which to determine taxable transactions, the auditors attempted to reconcile reported income from the Taxpayer's individual income tax returns to source documents, such as contracts or invoices, that would describe the activities.

Any company that pays more than \$600 to an independent contractor in one year is required to report this to the Internal Revenue Service (IRS) as well as to the contractor, using Form 1099-Misc (2007 RIA Federal Tax Handbook, Section 4751). Thus, in the absence of customary books of record, the auditors believed that tracing source documents to Form 1099-Misc was reasonable. In fact, relying only upon Form 1099-Misc may have understated the Taxpayer's total activity.

The Taxpayer's representative did not appear to agree with the Commission that a fully documented accounting of the Taxpayer's revenue was necessary. The source for the Commission's contention comes from both the Sales Tax Act and a sales tax administrative rule:

(c) Every seller, every retailer, and every person storing, using, or otherwise consuming in this state tangible personal property purchased from a retailer shall keep such records, receipts, invoices and other pertinent papers as the state tax commission may require. Every such seller, retailer or person who files the returns required under this act shall keep such records for not less than four (4) years from the making of such records unless the state tax commission in writing sooner authorizes their destruction (Idaho Code § 63-3624).

01. In General. Every retailer doing business in this state and every purchaser storing, using, or otherwise consuming in this state tangible personal property shall keep complete and adequate records as may be necessary for the State Tax Commission to determine the amount of sales and use tax for which that person is liable under Title 63, Chapter 36, Idaho Code.

a. Unless the State Tax Commission authorizes an alternative method of record keeping in writing, these records shall show gross receipts from sales or rental payments from leases of tangible personal property, including any services that are a part of the sale or lease, made in this state, irrespective of whether the retailer or purchaser regards the receipts to be taxable or nontaxable; all deductions allowed by law and claimed in filing the return; and the total purchase price of all tangible personal property purchased for sale or consumption or lease in this state.

b. These records must include the normal books of account ordinarily maintained by the average prudent businessman engaged in such business, together with all bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account, together with all schedules or working papers used in connection with the preparation of tax returns (IDAPA 35.01.02.11 Records Required and Auditing of Records).

Since the customary books of account were not maintained or available, the Commission finds it unusual that the representative could fault the auditor’s approach.

In a reconciliation of Form 1099-Misc income and total reported sales with source documents, the auditor found the following sales information (some dollar figures are rounded).

Tax Year	Invoices Available	Invoice Total	Form 1099 Misc Reported Income	Total Reported Sales per Income Tax Returns
2000	0	Not applicable	Unknown	\$144,892
2001	0	Not applicable	168,283	Not Available
2002	0	Not applicable	Unknown	\$136,734
2003	4	\$ 925	\$137,460	\$139,310
2004	3	\$1,122	\$ 98,491	\$ 98,491
2005	13	\$9,138	\$ 39,065	\$ 50,454

The Commission concludes that the auditor was fair in choosing year 2005 as the best sample of the poorly documented years’ activity. While the representative wants a sampling method that might show greater leniency, it is not in the best interests of the state to reward the Taxpayer for failing in its obligation to maintain required records. Neither is it the desire of the

Commission to seek the most punitive approach to determining a liability. After its review of the facts, the Commission agrees that the Bureau took a reasonable approach to fulfill its purpose.

The Taxpayer has not provided the Commission with information to establish that the amount asserted in the Notice of Deficiency Determination, as amended, is incorrect. As a result, the Commission will uphold the amended tax deficiency notice for the period August 1, 2000, through July 31, 2007. A determination of the State Tax Commission is presumed to be correct (*Albertson's, Inc. v. State, Dept. of Revenue*, 106 Idaho 810, 814, 683 P.2d 846, 850 1984), and the burden is on the taxpayer to show that the deficiency is erroneous (*Parsons v. Idaho State Tax Commission*, 110 Idaho 572, 574-575 n.2 Ct. App. 1986).

The Bureau added interest and penalty to the sales and use tax deficiency. The Commission reviewed these additions and found them to be appropriate per Idaho Code §§ 63-3045 and 63-3046.

WHEREFORE, the Notice of Deficiency Determination dated December 17, 2007, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES HEREBY ORDER that the Taxpayer pay the following tax, penalty, and interest:

<u>TAX</u>	<u>INTEREST</u>	<u>PENALTY</u>	<u>TOTAL</u>
\$10,569	\$3,868	\$528	<u>\$14,965</u>

Interest is computed through November 6, 2008, and continues to accrue until paid.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the taxpayer's right to appeal this decision is enclosed.

DATED this _____ day of _____, 2008.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____, 2008, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.
