

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)
[Redacted],) DOCKET NO. 21033
)
) DECISION
Petitioner.)
_____)

On June 24, 2005, the staff of the Sales, Use and Miscellaneous Tax Audit Bureau (Bureau) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination to Ms. [Redacted] and [Redacted] (taxpayer) proposing additional sales tax, use tax, penalty, and interest totaling \$418,055 for the period March 1, 1995, through February 28, 2002. In a letter dated August 25, 2005, the taxpayer filed a timely appeal and petition for redetermination. The petition stated disagreements of fact and law that the taxpayer wished to discuss at a hearing. The Commission held a hearing at the taxpayer’s request on June 23, 2008.

For reasons explained below, the Commission hereby issues this decision for an amended amount.

Background

The taxpayer manufactures and sells [Redacted]. The taxpayer was the subject of a seven-year sales and use tax audit because the taxpayer did not obtain a seller’s permit and did not file the required returns and taxes (Idaho Code §§ 63-3620, 63-3623 and 63-3633).

Issues, Analysis, and Applicable Tax Code

The following issues are restated from the taxpayer’s August 25, 2005, protest letter. The narrative contains additional details gathered from the June 23, 2008. hearing.

Issue 1: The facts of this issue are not in dispute. The taxpayer places large [Redacted] on the property of its customers. When it sells [Redacted] to its customers, it fills these

[Redacted]. The average purchase per customer is 20 tons, and the [Redacted] as required by the customer. Title to the on-site [Redacted] remains with the taxpayer, and the customers have uninterrupted use of them.

The taxpayer decides to whom it will sell supplements based on estimated sales volume. The [Redacted] customers are not cost effective. The taxpayer considers the [Redacted] cost and return on investment when pricing its [Redacted].

[Redacted].

[Redacted] Since the [Redacted] prior to use by the customer, the taxpayer believes that the [Redacted], and that their use is entitled to an exemption per Idaho Code § 63-3622D, commonly referred to as the production exemption. The auditor disagreed and held the purchase of the [Redacted] taxable.

In order for the production exemption to apply, the [Redacted] must fit one of these two exemption paragraphs from Idaho Code § 63-3622D:

(a)(2) 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.

(a)(3) Chemicals, catalysts, and other materials which are used for the purpose of producing or inducing a chemical or physical change in the product or for removing impurities from the product or otherwise placing the product in a more marketable condition as part of an operation described in subsection (a)(2) of this section....

These two paragraphs must be examined in light of exclusionary language found elsewhere in the same statute:

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

...

(2) Tangible personal property used in any activities other than the actual manufacturing, processing, mining, farming or fabricating operations such as office equipment and supplies, and equipment and supplies used in selling or distributing activities.

According to the taxpayer, the product is in a finished state when delivered to the customer. It is the passage of time before the first use, and between subsequent uses, that requires remixing so that it can be distributed properly. The taxpayer says that it will bear the economic loss if, when used properly, the [Redacted] fails to distribute the product correctly.

In the Commission's opinion, [Redacted]

The Commission does not believe that the exemption statute was intended to extend beyond the sale when the taxpayer has no physical control of the product. The taxpayer has not proved that title to the goods has not passed, despite agreeing to some warranty or guarantee conditions. The tax statute gives the Commission considerable latitude in its definition of what constitutes a sale:

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 (Idaho Code § 63-3612(1), emphasis added).

The taxpayer's customers merely follow instructions and recommendations in a manner similar to how thousands of products are sold and used. [Redacted].

This issue is not without its precedent in Idaho. A soft drink dispensing machine in a convenience store is not manufacturing a drink by virtue of mixing syrup with carbonated water

when a customer presses a lever, and this determination was upheld in *Kwik Vend Inc. v. Koontz*, 94 Idaho 166, 483 P.2d 928 (1971).

In *Kwik Vend*, the seller also claimed a production exemption for microwaves and vending machines because these machines produced a physical change in the sold goods or otherwise put them in a more marketable condition. While the Idaho Supreme Court agreed that the machines were used in processing raw materials, it ruled that the activity was related to selling rather than within the scope of the production exemption statute. Over 20 years later, the *Haener* court (*Idaho State Tax Commission v. Haener Bros., Inc.* 121 Idaho 741, 828 P.2d 304 1992) referenced *Kwik Vend* and did not dispute its conclusions.

The taxpayer alternatively believes that the use of [Redacted] qualifies for the farming exemption, but it is not clear if the taxpayer claims the exemption for itself or for its customers. Farming is a type of production that is specifically named in Idaho Code § 63-3622D.

The Commission disagrees that the taxpayer is farming or ranching on behalf of its customers as a contractor. A statute does grant contractor farmers an exemption for qualifying items (Idaho Code § 63-3622D(c)). In the present case, however, the taxpayer has no contractor relationship; it has only a sales agreement with respect to the [Redacted].

Further, the Commission disagrees that the taxpayer's customers can claim an exemption for the use of the [Redacted]. Since the customers did not purchase the [Redacted], they gain no economic benefit from an exemption. They have no purchase from which to withhold a tax imposed by the state. The customers are not the consumer; the taxpayer is.

Alternatively, the taxpayer contends that the [Redacted] qualify as tax exempt containers per Idaho Code § 63-3622E. In the relevant sub-paragraphs of this code section, the exemption is predicated on the container being sold with the contents. At no time did the taxpayer stipulate

that it sold the containers to its customers. The taxpayer expressly states that it always retains ownership of the [Redacted] it places on the customers' property:

Containers. There is exempted from the taxes imposed by this chapter the sale or purchase of containers in the following categories: ...

(b) **Containers when sold with the contents** if the sales price of the contents is not required to be included in the measure of the taxes imposed by this act.

(c) **Returnable containers when sold with the contents** in connection with a retail sale of the contents or when resold for filling. (Idaho Code § 63-3622E, in relevant part, emphasis added.)

Issue 2: The taxpayer protests tax asserted by the auditor on certain [Redacted] purchases and cites Rule 108 (IDAPA 35.01.02.108) in which there is a requirement that a [Redacted] charge a tax unless there is an exemption. From this administrative rule, the taxpayer concludes that tax on an untaxed [Redacted] is the unilateral responsibility of the seller to collect, and, failing that, the state has no rights against the buyer. Additionally, it says that since dealers are required to tax [Redacted] sales, this relieves the buyer of the need to provide proof (e.g., an invoice) that it paid the tax.

Rule 111 (IDAPA 35.01.02.111) details the records that a business is required to keep for the Commission to determine sales and use tax liability and if that liability has been paid. The Commission routinely audits the records of buyers for the purpose of sales tax, and it knows of no prohibition against holding a tax in the absence of proof that the buyer paid the tax.

There are several related issues. The taxpayer purchased, sold, and transferred [Redacted]. The Commission is unsatisfied with the documentation related to some of these sales. The taxpayer is not a dealer, but as a retailer, it is required to collect tax on [Redacted] asset sales (Idaho Code § 63-3610(c)), unless the customer has a valid exemption. Although a

dealer should collect tax from the taxpayer when it buys [Redacted]. On transfers, the taxpayer can make non-taxed transfers between related companies, but the taxpayer must prove it paid tax on the original purchase in order for the transfer to be exempt (Idaho Code § 63-3622K).

Issue 3: The auditor asserted tax on [Redacted] machinery. The taxpayer contends that all sales were either part of nontaxable trade-ins or were sales to people qualifying for the production exemption. Record keeping requirements and the production exemption, both noted previously, are at issue here.

The Commission has no proof from the taxpayer (a valid exemption certificate required by Idaho Code § 63-3622) that a customer who bought a particular fixed asset claimed an exemption for that purchase. Although the taxpayer describes the item as a [Redacted], the Commission believes that it could be used for a non-farm purpose and would, therefore, be taxable.

Consistent with policy and statutes, the auditor claims that certain untaxed [Redacted] exempt. These include a pressure washer and weighing scales. The Commission believes these items are for janitorial purposes and selling/transportation purposes respectively and no exemption applies (Idaho Code § 63-3622D(f), (g)(2), and (g)(3)).

Issue 4: The auditor held certain sales as taxable, but the taxpayer characterized them as intercompany transfers. Intercompany transfers, the taxpayer says, are transfers between divisions and are documented by accounting entries rather than by the exchange of consideration (i.e. money) as they are in arms' length transactions. The Commission disagrees, believing that available evidence shows the exchanges were actually sales between separately incorporated entities.

The auditor disallowed the untaxed sales because the taxpayer could not prove that the original purchase was taxed, a requirement of Idaho Code § 63-3622K(b)(4), for the seller and the buyer to conduct the transaction tax free. Other sales were held taxable because there was no sufficient information to determine if the sale or use of the goods would qualify for the production exemption.

Issue 5: The taxpayer argues that out-of-state sales held as taxable are exempt (Idaho Code § 63-3622P). The taxpayer did not provide documentation proving that the questioned items were shipped to a point out-of-state.

Issue 6: The taxpayer maintains that gifts or samples are not sold and, therefore, are not subject to tax. [Redacted] from resale inventories were donated or given away for promotional purposes. Such uses are taxable to the retailer per Idaho Code § 63-3622(c) and IDAPA 35.01.02.105.06.b.

Issue 7: The taxpayer claims that any reimbursement it made to two Washington employees for incurred expenses on its behalf is not taxable in Idaho because the expenses were either incurred out-of-state or were taxed in Idaho. The taxpayer was not able to show what the expenses were, or if tangible personal property was purchased in Idaho or was eventually delivered to the state.

Issue 8: The auditor held undocumented lease expenses taxable. The taxpayer claims that tax was paid through [Redacted] at issue. Internally used truck identification numbers were re-used in the accounting system resulting in confusion and the taxpayer's inability to provide the appropriate audit evidence.

The taxpayer argues that a vehicle was used in [Redacted] and that tax was paid there, but the auditor found that it was licensed and titled in Idaho as a lease from [Redacted]. Tax

erroneously paid to another state cannot serve as an Idaho credit for tax owed (IDAPA 35.01.02.072.07). Although several objections to taxable amounts under Issue 8 were eventually decided in the taxpayer's favor following the Notice of Deficiency Determination, there remain some taxable amounts where the taxpayer has either not provided records or has not provided sufficient records.

Issue 9: Two of the taxpayer's divisions have a combined total of [Redacted] registered with the International Registration Program (IRP). The purchase and use of [Redacted] registered with the IRP and meeting a minimum 10 percent out-of-state mileage requirement during a registration period are exempt from sales or use tax, as discussed previously (Idaho Code § 63-3622R(c)).

[Redacted] records showed when each fleet did not comply with the minimum out-of-state mileage requirement. Consequently, the auditor asserted tax on the fair market value of the vehicles. The taxpayer first proposes that all four fleets of one of its divisions be examined as a combined entity for the purpose of the exemption. Presumably, the combined fleet will pass the mileage threshold, where individually, the fleets would not. The Commission declined to do so for a similarly situated taxpayer in a previously protested sales and use tax audit (Idaho State Tax Commission Decision #19508, January 2007).

If the taxpayer failed to convince the Commission of the preceding approach, it asks the Commission to use book values as taxable amounts, rather than use estimated market values. The Commission believes that the auditor chose correctly, using figures that reflect sales prices rather than entries that serve accounting or business income tax purposes.

The taxpayer also states that some trucks' values were held taxable twice, but the documentation is unconvincing.

Issue 10: Some of the tax liability is an estimate made against errors found in sampled records. The taxpayer asks that the projection of liability be recalculated after certain protested taxable amounts are reduced in its favor. The Commission revised the projections for schedules that changed as a result of new information that lowered the taxable amounts. This is routinely done for examinations that involve error rates based on sampled records.

Issue 11: The taxpayer protests the penalty, saying it acted with reasonable cause and in good faith, although it admits no liability (Idaho Code §§ 63-3624 and 3634). The Commission used discretion allowed by the tax statute to lower the penalty from a 25 percent non-filer penalty to a 5 percent negligence penalty.

Issue 12: The taxpayer protests the addition of interest charges for the time period in which the audit staff held the case file and did not forward it to the Legal and Tax Policy section of the Commission for the hearing process.

The Commission issued the Notice of Deficiency Determination on June 24, 2005 and referred the file to Legal and Policy on April 1, 2008. In the time immediately following the taxpayer's protest of the deficiency (August 25, 2005), the auditor kept the file anticipating that the taxpayer would provide additional documentation in its defense. This procedure is not out of the ordinary.

The lapse of time beyond a reasonable period before a hearing is regrettable. However, the taxpayer was not without its remedies had it chosen to exercise them. The Commission notes that since August 17, 2005, the taxpayer has been represented by a law firm that was presumptively aware of the applicable tax codes and could have intervened to stop the accrual of interest. The taxpayer could have paid the liability under protest, which would have stopped the further accrual of interest. Had the taxpayer later prevailed in its protest against the

Commission, the amount not owed would have been returned, with interest (Idaho Code § 63-3049 and 63-3073). Also, the taxpayer had the beneficial use of the money; hence, interest accrual does not harm the taxpayer.

At any time following the Notice of Deficiency Determination, the taxpayer or its representative could have requested a hearing or required the Commission to issue a decision. That decision would have been provided within 180 days of a request or 180 days following the hearing date (Idaho Code § 63-3045B(3)(a) and (b)).

As noted earlier, the extraordinary time lapse is regrettable. However, the income tax interest provisions of Idaho Code § 63-3045, that apply to sales tax deficiencies as well (Idaho Code § 63-3632), are clear:

Interest upon any deficiency shall be assessed at the same time as the deficiency, shall be due and payable upon notice and demand from the state tax commission **and shall be collected** as a part of the tax at the rate per annum determined under the provisions of subsection (6)(c) of this section from the date prescribed for the payment of the tax. (Idaho Code § 63-3045(6)(b), emphasis added.)

In 1983, the Idaho Supreme Court affirmed the Commission's obligation to both assess and collect interest in a decision against the Union Pacific Railroad Company's appeal of a 1942 Idaho state income tax and accrued interest assessment. The court said that despite unique circumstances and its own ability to exercise equitable power, absent statutory authority, it had no power to remit (i.e., abate) interest imposed by statute on a tax deficiency. *Union Pacific Railroad Company v. State Tax Commission*, (670 P.2d 878 at 475-476).

Adjustment of Liability

As noted previously, there were occasions where the Commission adjusted the tax deficiency in the taxpayer's favor based on additional documentation and explanations provided by the taxpayer.

Absent additional information to the contrary, the Commission finds the deficiency prepared, and later adjusted, to be an accurate representation of the taxpayer's sales and use tax liability for March 1, 1995, through February 28, 2002.

The Bureau added interest and penalty to the tax deficiency. The Commission reviewed this addition and found them appropriate per Idaho Code §§ 63-3045 and 63-3046. The Commission exercised its authority to reduce the penalty from 25 percent of the tax to 5 percent of the tax. Interest is calculated to December 31, 2008 and continues to accrue until the liability is paid.

WHEREFORE, the Notice of Deficiency Determination dated June 24, 2005, as MODIFIED, is APPROVED, AFFIRMED, and MADE FINAL.

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

<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
\$225,406	\$11,270	\$147,449	\$384,125

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.
