BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of **[Redacted]** Petitioner.	))))))	DOCKET NO. 0-458-706-944 DECISION

On January 29, 2016, 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 (Notice) to **[Redacted]** (Petitioner), proposing sales tax, use tax, and interest for the period March 1, 2008, through October 31, 2011, in the total amount of $213,186.

On March 25, 2016, Petitioner filed a timely appeal and petition for redetermination of the Notice. At Petitioner's request, the Commission held an informal hearing on November 4, 2016. Present at the informal hearing was Commissioner **[Redacted]**, Deputy Attorney General **[Redacted]**, and Tax Appeals Specialist **[Redacted]**.

The Commission is fully advised of the contents of the audit file, as well as information obtained at the hearing and thereafter and hereby issues its decision to uphold the Notice.

BACKGROUND AND AUDIT FINDINGS

Petitioner manufactures and packages various **[Redacted]** products for resale. The Bureau conducted a routine comprehensive audit of Petitioner's business for the purpose of determining compliance with Idaho sales and use tax law. The Bureau identified untaxed purchases in its examination of ordinary purchases, fixed asset purchases, and employee **[Redacted]** purchases.

At issue in this case is the Bureau's imposition of tax on supplies that Petitioner believes should qualify for the production exemption and a pallet racking system that Petitioner had installed into it's warehouse. Petitioner agrees with the Bureau's imposition of sales and use tax in all other respects.

PROTEST ANALYSIS

Supplies

Petitioner protested the imposition of use tax on certain supplies that it believes should have qualified for exemption under Idaho Code § 63-3622D, commonly known as the "production exemption." This exemption excludes tax on the sale, purchase, or use of items primarily and directly used in a production process. The Bureau contends that the supplies in question are taxable because they fall within two exclusions to the production exemption.

Transportation Supplies - The first exclusion identified by the Bureau was for supplies used in the transportation of the finished good, specifically slip-sheets and pallets. Idaho Code § 63-3622D(g)(2) excludes property used in transportation activities from the production exemption.

The Bureau found that once the production process is complete, Petitioner places its finished product on slip-sheets before they are put on pallets. Slip-sheets are a thin pallet-sized sheet made of cardboard or plastic, that helps ensure that the product does not sustain any damage when it is palletized. The slip-sheet and the product are then placed upon a pallet. Petitioner does not shrink-wrap the product to the slip-sheet and pallet before the product is shipped.

In general, when a manufacturer shrink-wraps its product to shipping materials, those shipping materials are treated as part of the packaging or container the product is being sold in. Idaho Code § 63-3622E exempts the sale or purchase of 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. IDAPA 35.01.02.084 states that a container "encloses or will enclose tangible personal property which is sold at wholesale or retail."

In this case, Petitioner does not shrink-wrap the product it manufactures to the slip-sheet and pallet before the product is shipped, therefore the Bureau held that this does not constitute a

container.

IDAPA 35.01.02.084.04 states that "[s]hipping, selling, or distribution supplies are not considered to be containers and are subject to the tax when purchased by the shipper, seller, or distributor" and identifies shipping pallets when not banded to the product to be sold, as one of these supplies. The Bureau determined that both the slip-sheets and shipping pallets fell under the category of transportation supplies. Transportation supplies are specifically excluded from the production exemption and are subject to tax.

Petitioner argues that all of the shipping techniques and materials it uses are for the protection of its product and are not materially different than what the Bureau considers to be a container. Whether the product is shrink-wrapped to the shipping supplies or not, it will leave the warehouse on those supplies.

The Commission agrees that both slip sheets and pallets when not banded to the product to be sold, are shipping supplies and do not constitute a container. Therefore, they do not qualify for exemption under Idaho Code § 63-3622E. The Commission also agrees that these supplies are transportation supplies and as such are excluded from the production exemption provided in Idaho Code § 63-3622D.

Chemical Supplies - The second exclusion identified by the Bureau was for supplies used in a "maintenance" or "janitorial" function. Idaho Code § 63-3622D(f) excludes supplies used in a manner that is incidental to the manufacturing process, such as maintenance and janitorial supplies.

Of the forty-one (41) different chemical supplies purchased by Petitioner during the audit period, the Bureau identified nine (9) that it held did not qualify for the production exemption because they were used for cleaning surfaces and equipment when the production process was

complete.

Petitioner protested the imposition of tax on these chemical supplies, asserting that they qualify for the production exemption and are used to sanitize production equipment and the production area. Petitioner affirms that they are necessary in order to meet established USDA/FDA requirements for the manufacture and lawful distribution of Petitioner's **[Redacted]** products.

Petitioner points to the specific provision in the production exemption:

> "[c]hemicals, 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, and chemicals and equipment used in clean-in-place systems in the food processing and food manufacturing industries."

Idaho Code § 63-3622D(a)(3).

Petitioner asserts that this section is directly on point to its argument because it is "removing impurities" when it uses the chemicals to clean the production equipment and the production area resulting in a product that is more marketable.

The Commission does not agree that chemicals used to sanitize production equipment and the production area after the production process is complete are exempted by Idaho Code § 63-3622D(a)(3). The chemical supplies that were held do not produce or induce a chemical or physical change in the product nor do they remove impurities from the product. The chemical supplies used by Petitioner do not directly remove impurities from the product, rather, they clean up the production area after the process is complete.

The Bureau held the use of these chemical supplies taxable because of the exclusion in subsection (f). In reviewing the relevant code and rules, the Commission finds no additional

explanation or definition for what might fall under "maintenance and janitorial equipment and supplies." However, the process of sanitizing production equipment and the production area after the production process is complete has been consistently held by the Commission as a maintenance or janitorial function, with the exception of a clean-in-place system. The chemical supplies in question are not used in a clean-in-place system.

Petitioner's use of the chemical supplies in this case fall outside of the exemption allowed by the statute. Additionally, because tax exemptions are a matter of legislative grace rather than a guaranteed right, the exemption must be strictly and narrowly construed against the taxpayer and in favor of the state. *Idaho State Tax Commission v. Haener Bros.*, 121 Idaho 741, 828 P.2d 304 (1992).

Pallet Racking System

During the audit period Petitioner contracted with a vendor to design and install a pallet racking system for its warehouse. The Bureau determined that the pallet racking system is the sale of tangible personal property and held that the fees associated with putting the system into the warehouse according to Petitioner's specifications are subject to sales tax.

Petitioner protested the imposition of tax on the pallet racking system, asserting that the racking was installed into a leased property and is accounted for under Internal Revenue Service (IRS) regulations as a permanent leasehold improvement rather than tangible personal property. Petitioner asserts that it is not the owner of the pallet racking system. Petitioner posits that the pallet racking system meets the definition of real property found in IDAPA 35.01.02.067 and uses the three-factor test found there to illustrate how the pallet racking system is a real property improvement.

Petitioner's assertion that pallet racking system qualifies as a permanent leasehold

improvement under IRS regulations does not change how the property would be classified for the purposes of sales tax. In Idaho, the definition of real property and tangible personal property can vary between tax types. Petitioner's supposition that the definition of the property for income tax purpose somehow controls how that property should be classified for sales tax purposes is erroneous. Sales tax has its own set of definitions that must be used when determining the nature of a transaction.

In this case, IDAPA 35.01.02.010.16 defines real property as "land and improvements or fixtures to the land." A contractor improving real property is defined by IDAPA 35.01.02.010.04 as "any person acting as a general contractor, subcontractor, contractee, subcontractee, or speculative builder who uses material and equipment to perform any written or verbal contract to improve, alter, or repair real property."

Idaho Code § 63-3609(a) states that a contractor improving real property is the consumer of the material it uses. If the vendor in this case was in fact improving real property, it would have had a responsibility to pay sales tax on all of its materials. In the event that it is determined that the pallet racking system is, in fact, an improvement to real property, the tax burden shifts from Petitioner to its vendor.

The Commission is perplexed by Petitioner's assertion that it is not the owner of the pallet racking system that it paid $372,935 for during the audit period. Even more so after reading the documentation provided by Petitioner in support of its assertion. Petitioner provided the following documentation:

1. Lease Amendment dated December 1, 2005 that outlines terms under which Petitioner would be allowed to expand a portion of the Dry Warehouse. The amendment specifies that the expansion will need to be completed by 01/31/2006. The amendment gives Petitioner the

right to move existing racking owned by the Landlord as a part of the expansion and specifies that the existing racking will remain the property of the Landlord.

2. A 5-year lease agreement, dated January 30, 2008 that states that "any shelving/racking systems installed by the lessee which are attached to the building for stabilization shall be deemed as a trade fixture and Lessee shall have the right to remove such shelving/racking as long as the Lessee repairs any damage to the building where attached."

The first document, signed years prior to the purchase of the racking at issue, identifies existing racking owned by the Landlord and gives Petitioner the right to move that racking. There is no indication that the racking will ever become the property of Petitioner.

In contrast, the 2008 lease agreement identifies any shelving/racking systems installed by Petitioner into the leased property as "trade fixtures." Petitioner has the right to remove the trade fixtures as long as it repairs any damage to the building as a result of the removal of those trade fixtures.

IDAPA 35.01.02.067 provides guidance regarding determining whether a particular article has become a fixture to real property or remains tangible personal property:

> 067. Real Property (Rule 067), in part,
>
> **01. Improvements or Fixtures**. Improvements or fixtures to real property include:
>
> **a.** Property which is physically attached to the land or other improvements affixed to the land in such a manner that it may not be removed without materially damaging the real property or is of such a nature that it would normally be expected to be sold together with the land.
>
> **b.** Property which increases the market value of the land or increases the ability of the possessor of the land to use it more productively.
>
> **c.** Property which increases the market value or productivity on a relatively permanent basis.
>
> **02. Three Factor Test**. A three (3) factor test may be applied to determine whether a particular article has become a fixture to real property. The three (3) tests to be applied are:

[Redacted]

a. Annexation to the realty, either actual or constructive.

b. Adoption or application to the use or purpose to which that part of the realty to which it is connected is suitable.

c. Intention to make the article a permanent addition to the realty.

03. Example 1: The original builder or owner of an apartment building installs draperies. The draperies meet the three (3) factor test of a fixture to realty. First, they are constructively annexed to the realty when attached to the drapery rod. Although the draperies are not affixed to the realty, they comprise a necessary, integral, or working part of the object to which they are attached. Second, they appropriately adapt to the purpose of the realty to which they are connected. Window coverings are necessary in order to maintain occupancy of the apartment. The third and controlling factor in this example is the intention with which the installation was made. The intention must be determined from the surrounding circumstances at the time of installation. It is not the undisclosed purpose of the annexor, but rather the intention implied and manifested by his act. The builders intended that the drapes would remain as long as they served their purpose.

04. Example 2: The three (3) factor test would not be met in Subsection 067.03 of this rule, if the drapes were installed by a tenant of an apartment leased for a term with no agreement as to ownership. The tenant would be expected to remove or sell the drapes to an incoming tenant, and his intention would be the controlling factor. The draperies would not be considered as fixtures to the real property.

05. Personal Property Incidental to the Sale of Real Property. This rule does not affect the provisions of Section 63-3609(b), Idaho Code.

06. Store Fixtures. Store fixtures are items that are affixed to a building and used by retailers in the conduct of their business. The term "store fixtures" includes display cases, trophy cases, clothing racks, shelving, modular displays, kiosks, wall cases, register stands, and check-out counters. If store fixtures only benefit the particular business occupying a building, they are not adapted to the use of the real estate and are therefore personal property. A store fixture will only be deemed to be a real property improvement if:

a. It is affixed to the real estate and its removal would cause significant structural damage to the building itself; or

b. It is affixed to the real estate and is of benefit to the land or building regardless of the particular business conducted on the premises.

IDAPA 35.01.02.067, in part.

The Commission has analyzed the facts in this case and applied the law and IDAPA 3501.02.067. The Commission affirms the Bureaus conclusion that the installation of the shelving/racking system in question was not a real property improvement.

CONCLUSION

On appeal, a deficiency determination issued by the Commission "is presumed to be correct, and the burden is on the taxpayer to show that the Commission's decision is erroneous." *Parker v. Idaho State Tax Comm'n*, 148 Idaho 842, 845, 230 P.3d 734, 737 (2010) (*citing Albertson's Inc. v. State Dep't of Revenue*, 106 Idaho 810, 814, 683 P.2d 846, 850 (1984)). The Commission requires Petitioner to provide adequate evidence to establish that the amount asserted in the Notice is incorrect. Here, Petitioner did not provide adequate evidence. As a result, the Commission will uphold the Notice.

Absent information to the contrary, the Commission finds the Notice prepared by the Bureau to be a reasonably accurate representation of Petitioner's sales tax and use tax liability for the period March 1, 2008, through October 31, 2011.

The Bureau added interest to the sales tax and use tax deficiency. The Commission reviewed that addition and found both to be appropriate per Idaho Code § 63-3045.

THEREFORE, the Notice of Deficiency Determination dated January 29, 2016, is hereby APPROVED, in accordance with the provisions of this decision, and is AFFIRMED and MADE FINAL.

The Notice of Deficiency Determination has been paid in full by Petitioner; therefore, no demand for payment is made or necessary.

An explanation of Petitioner's right to appeal this decision is included with this decision.

DATED this _____ day of _____, 2017.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____, 2017 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.

_____