DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS NUMBERS: 00-0236 AND 00-0237
Gross Retail and Use Tax
For Tax Years 1996-1998

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ISSUE

I. Gross Retail and Use Tax—Characterization of Restaurant Equipment Under Rehearing Standard of Review

Authority: **IC § 6-8.1-5-1(f)** **45 IAC 15-5-3(8)**
45 IAC 15-5-5
Indianapolis Fruit Co., v. Department of State Revenue, 691 N.E.2d 1379(Ind.Tax 1998); Sales Tax Information Bulletin # 55

Taxpayer originally protested, among other items, Audit's characterization of 2 different kinds of restaurant equipment as ineligible for partial production process exemptions. The original Letter of Findings denied taxpayer's protest, and taxpayer timely requested a rehearing on just 2 items. Taxpayer's request was granted and a rehearing held.

STATEMENT OF FACTS

Taxpayer owns and operates 2 restaurants in the state of Indiana. An examination of taxpayer's invoices for the calendar years 1996, 1997, and 1998 showed that taxpayer failed to pay sales tax on certain items of tangible personal property for which no exemption applied. The audit resulted in proposed assessments of use tax. Taxpayer protested these assessments, and a hearing was held on April 3, 2001, and the original Letter of Findings was issued on June 15, 2001. Taxpayer timely requested a rehearing which was granted and held on September 18, 2001. Additional facts will be supplied as necessary.

I. Gross Retail and Use Tax—Characterization of Restaurant Equipment Under Rehearing Standard of Review

DISCUSSION

Taxpayer, in its previous protest, had questioned Audit's characterization of some of its restaurant equipment for purposes of determining the percentage of electricity consumed in its production process. Specifically, taxpayer had contended that a large walk-in refrigeration unit

and an exhaust filter system should have been characterized as production equipment for purposes of computing percentages of exempt utility consumption.

Taxpayer had presented the following facts at the original hearing: taxpayer cuts and "ages" its own steaks. The aging process requires restaurant personnel to store purchased beef in a refrigeration unit prior to final cutting and cooking. Taxpayer still believes the refrigeration unit is an essential and integral part of its production process. The "aging process" at issue consists of placing meat in a controlled refrigerated environment. Cold storage allows natural enzymes already contained in the beef to break down the hard, connective tissues. The result of this biochemical process is a tender, more flavorful steak. Given the refrigerator's utility, and its impact on marketing strategy, taxpayer still contends the unit is essential to its integrated production process.

The Letter of Findings the Department issued after the original hearing cited *Indianapolis Fruit Co., v. Department of State Revenue*, 691 N.E.2d 1379 (Ind.Tax 1998) as authority for rejecting taxpayer's argument because the Tax Court, in *Indianapolis Fruit*, heard and rejected similar arguments. In *Indianapolis Fruit*, the taxpayer had argued that tomatoes were ripened and made more marketable through storage "in a tightly controlled environment," much like the instant taxpayer's refrigeration unit. (*Id*. At 1385). The Tax Court rejected this argument and found that tomato ripening did not constitute production "within the meaning of any of the exemption provisions." *Id.* The Court went on to state unequivocally that the transformation of the tomatoes into a "more marketable" product was not caused by anything Indianapolis Fruit did to them: "Instead, [Indianapolis Fruit] passively awaited the ripening of the tomatoes. The ripening was not actively induced by Indianapolis Fruit and was merely incidental to the proper storage of the tomatoes." (*Id*. at 1385-86).

In the case at bar, the Department, in the original Letter of Findings, determined the rule and rationale announced in *Indianapolis Fruit* precluded the Department from arriving at a different result in taxpayer's case. Taxpayer's "aging" of beef did not represent a production activity because taxpayer did not actively induce the changes caused by the aging process. Very similar to the taxpayer in *Indianapolis Fruit*, the present taxpayer merely waited for the process to complete itself. This is biochemistry, not production; the aging "event", similar to the tomato ripening "event," is "merely incidental to the proper storage of the" beef. (*Id.*) Audit's original refusal to characterize the refrigeration unit as production equipment was deemed correct.

Taxpayer argued in its original protest that an exhaust filter system should have been characterized as production equipment. At the original hearing, taxpayer's description of the system and how it functioned was sufficient to reveal the health and safety nature of the system. Audit's determination that the production exemption should not apply was upheld in the original Letter of Findings.

Pursuant to IC § 6 –8.1-5-1(b) and 45 IAC 15-5-3(8), a "notice of proposed assessment is *prima facie* evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Therefore, the burden remains with the taxpayer to overcome the presumption that a

duly promulgated tax assessment is correct. In addition, the standards on rehearing are more restrictive than those followed in an original taxpayer protest hearing.

The Department, in original taxpayer protest hearings, always explains the standards for granting requests for rehearing. Pursuant to IC § 6-8.1-5-1(f), a taxpayer who "disagrees with a decision in a letter of finding may request a rehearing" within 30 days of the Letter of Findings' issuance. The Department "shall consider the request and may grant the rehearing." Under 45 IAC 15-5-5(b), rehearings are not held "*de novo* unless abuse of discretion is alleged." If taxpayer alleges such an abuse, "the evidence will not be reweighed." In such cases where abuse of discretion is alleged, the Department only considers "evidence most favorable to the department's position" and reverses the original letter of finding's determinations "only if the decision is clearly against the logic and effect of the facts and circumstances." If a taxpayer on rehearing "presents new and relevant evidence as a grounds for reversal, the new evidence will be weighed in light of all relevant facts and circumstances."

At the rehearing, taxpayer voiced several objections to the original Letter of Findings, i.e., the lack of particular findings regarding the functions of the walk-in refrigeration unit and the exhaust system. Specifically, taxpayer argued that the meat aging process is only one function of the uses of the unit; taxpayer also argued that the exhaust system is not analogous to the HVAC system on which the original Letter of Findings relied.

Taxpayer emphasized the unique nature of the product his restaurants sell for public consumption:

1. **Steaks—**Taxpayer purchases meat in bulk, carves it into steaks of various kinds and sizes, and then stores them in the unit until customers order. At that point, staff move inventory from the unit to the kitchen where the steaks are stored until grilled on the open flame grill. Steaks are stored in the unit in sealed trays which are moved to the kitchen as required by customer volume.
2. **Salads—**Taxpayer purchases typical salad ingredients whole and in bulk, not prepackaged. In particular, taxpayer purchases heads of lettuce, cores them, washes, dries, and shreds them, placing the resulting product in sealed plastic bags and storing them in the unit with tomatoes, etc, until they are moved to the salad "station" where the ingredients are combined into the different salad varieties customers may order.
3. **Bread and rolls—**Taxpayer purchases all ingredients for bread and rolls, mixes them up into dough, and stores the dough in plastic bags in the unit until needed for processing into freshly baked goods to fill customer orders.
4. **Ground beef—**Taxpayer takes meat and fat leftover from the steak carving process, grinds them up, rolls them into balls, and stores them in the unit until customers order dishes such as hamburgers, ground steak, etc.

Taxpayer argued that his steak products and their accompanying salads and rolls, as produced now, could not be produced without the operation of the walk-in refrigerator and the exhaust system. Taxpayer maintains that his restaurants offer customers a dining experience that is harder

and harder to find these days—freshly prepared food from freshly purchased ingredients, stored and prepared in a unique way.

In support of his contentions, taxpayer played a videotape of kitchen staff cooking steaks to order. No unusual activity occurred; staff removed various cuts of steaks from kitchen storage (not the walk-in cooler) and tossed them onto the open flame grill. Smoke rose up and disappeared into the exhaust system for venting outdoors. There is nothing special about taxpayer's preparation or storage processes that would require the Department to classify steaks, dough, and salad ingredients as works in progress.

Taxpayer presented nothing at the rehearing to challenge Audit's original determination and the first Letter of Findings. *Indianapolis Fruit* and Sales Tax Bulletin # 55 still apply. Taxpayer's arguments do nothing to impugn Audit's original determination, or to discredit the original Letter of Finding's denial of taxpayer's protest on these issues. Rather, the videotape and taxpayer's arguments on rehearing merely serve to emphasize taxpayer's original facts and arguments: Taxpayer's restaurants create a unique product which qualify them, if the Department truly understood, for a greater percentage of electricity used in its production process. The Department, while understanding taxpayer's point of view, and product, declines taxpayer's invitation to expand the statutory and regulatory definitions delineating production processes to increase exempt electrical usage.

FINDING

Taxpayer's protest was properly denied in the original Letter of Findings.

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