DEPARTMENT OF STATE REVENUE

04-20170763.LOF

Letter of Findings Number: 04-20170763
Use Tax
For Tax Years 2013, 2014 & 2015

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Indiana Department of Revenue's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Indiana Restaurant Franchisee was able to produce documentation and explanation showing a higher exemption rate for utility usage than originally determined by the Department, thus entitling Indiana Restaurant Franchisee to predominant use tax exemption on utility purchases.

ISSUE

I. Use Tax–Utilities - Predominant Use Exemption.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; *Aztec Partners, LLC v. Indiana Dep't of State Revenue*, 35 N.E.3d 320 (Ind. Tax Ct. 2015); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); 45 IAC 2.2-3-4; 45 IAC 2.2-4-13.

Taxpayer protests the imposition of use tax on utilities.

STATEMENT OF FACTS

Taxpayer owns and operates two franchised fast-food restaurant locations in Indiana. One location operates 24 hours per day and the other operates 18 hours per day. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer did not pay sales tax on all of its taxable utility usage for the tax years 2013, 2014, and 2015. The Department therefore issued proposed assessments for use tax and interest for those years. The audit did not impose additional penalties on the use tax assessments.

Taxpayer had previously been granted partial exemptions based upon utility studies submitted by Taxpayer in June 2011, which the Department accepted. In July 2015, Taxpayer submitted updated utility studies to the Department, claiming predominant use exemption. The Department reviewed the application and granted the predominant use exemption and an ST-109 was issued to Taxpayer in April 2016 for each location. Taxpayer's electricity utility provider stopped assessing Indiana sales tax on Taxpayer's electricity purchases after March 2016.

The Department subsequently audited Taxpayer for tax years 2013, 2014, and 2015, and the utility exemptions were reviewed as part of that audit in order to determine whether Taxpayer was entitled to the predominant use exemption. Following a tour of Taxpayer's restaurant locations, the Department determined that Taxpayer qualified for 40 percent and 45 percent exemptions for sales tax paid on the purchase of electricity used in the production process for each store. The auditor relied upon metered results from a similar, but separately owned, restaurant to determine the kilowatt hours consumed by various pieces of equipment used in the food production process. However, the metered results were for a 24-hour restaurant and had been completed 12 years prior to Taxpayer's audit.

Taxpayer protested the imposition of use tax on the utility purchases, asserting that it was entitled to a 100 percent predominant use exemption. An administrative hearing was held at which Taxpayer and Taxpayer's representative explained the basis for the instant protest. This Letter of Findings results. Further facts will be supplied as required.

I. Use Tax– Utilities - Predominant Use Exemption.

DISCUSSION

The audit report found that Taxpayer was not entitled to the predominant use exemption on the purchase of electricity because Taxpayer did not meet the 50 percent usage threshold necessary for the exemption. Specifically, the audit found that some equipment included in Taxpayer's utility study was not present during the auditor's tour of the store, and that Taxpayer had overstated the kilowatt usage of the equipment that was present. The auditor instead substituted Taxpayer's utility study with metered results from another franchise location, stating that "[i]t is the opinion of the auditor that these metered results are more than favorable to the taxpayer since the results were obtained from a very high volume store, the same type of equipment is used by all stores, and the metered results were from a store that was open 24 hours."

Taxpayer protests the imposition of use tax on its purchase of utilities at the two restaurants it owned and operated during the tax years at issue. Taxpayer argues that the audit improperly disregarded Taxpayer's 2015 utility study, which showed that it was entitled to a predominant use tax exemption, and instead relied upon a study from a different location that used outdated information.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The 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." *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[w]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

Sales tax is imposed by IC § 6-2.5-2-1, which states:

> (a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.
>
> (b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

Use tax is imposed by IC § 6-2.5-3-2(a), which states:

> An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

45 IAC 2.2-3-4 further explains:

> Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

Therefore, when tangible personal property is used, stored, or consumed in Indiana, use tax is due if sales tax was not paid at the time of the transaction, unless an applicable exemption is available.

An exemption from sales and use tax is provided for tangible personal property purchased for use in direct production of other tangible personal property. This exemption is found in IC § 6-2.5-5-5.1, which states:

> (a) As used in this section, **"tangible personal property" includes electrical energy, natural or artificial gas, water, steam, and steam heat**.
>
> (b) Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining,

repairing, mining, agriculture, horticulture, floriculture, or arboriculture. This exemption includes transactions involving acquisitions of tangible personal property used in commercial printing.

In the case of electrical usage, 45 IAC 2.2-4-13 explains:

(a) In general, the furnishing of electricity, gas, water, steam, or steam heating services by public utilities to consumer is subject to tax.

(b) The gross receipt of every person engaged as a power subsidiary or a public utility derived from selling electrical energy, gas, water, or steam to consumers for direct use in direct manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in IC 6-2.5-4-5 shall not constitute gross retail income of a retail merchant received from a retail transaction. Electrical energy, gas, water, or steam will only be considered directly used in direct production, manufacturing, mining, refining, oil or mineral extraction, irrigation, agriculture, or horticulture if the utilities would be exempt under IC 6-2.5-5-5.1.

(c) Sales of public utility services or commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in IC 6-2.5-4-5, based on a single meter charge, flat rate charge, or other charge, are excepted if such services are separately metered or billed and will be used predominantly for the excepted purposes.

(d) Sales of public utility services and commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, or horticulture, based on a single meter charge, flat rate charge, or other charge, which will be used for both excepted and nonexcepted purposes are taxable unless such services and commodities are used predominantly for excepted purposes.

(e) **Where public utility services are sold from a single meter and the services or commodities are utilized for both exempt and nonexempt uses, the entire gross receipts will be subject to tax unless the services or commodities are used predominantly for excepted purposes. Predominant use shall mean that more than fifty percent (50[percent]) of the utility services and commodities are consumed for excepted uses.**
(**Emphasis added**).

Therefore, if 50 percent or more of electricity sold from a single meter is used in an exempt manner, the purchaser/taxpayer is considered to have predominantly used the electricity for exempt purposes and the electricity sold through that meter is wholly exempt from sales tax and use tax. In order to qualify for the exemption, a taxpayer must show that "1) it is engaged in production, 2) it has an integrated production process, and 3) the electricity is essential and integral to its integrated production process." *Aztec Partners, LLC v. Indiana Dep't of State Revenue*, 35 N.E.3d 320, 324 (Ind. Tax Ct. 2015).

The audit determined that Taxpayer's restaurants did not qualify for the predominant use exemption and recalculated the percentage of exempt use of the utilities. The Department's recalculations for exempt usage rates were 45 percent and 40 percent for the two locations. The Department based its determination that the two restaurants' utility usage was not predominantly exempt on metered results from a separate restaurant within the same franchise, concluding that these figures were "more favorable" to Taxpayer. In response to Taxpayer's argument that menu items, equipment, cooking times, and cooking techniques have changes within the past 12 years since the study the Department relied upon, the audit report stated, "A sandwich name may change because of the different dressings but a hamburger is still a hamburger, and a chicken sandwich is still a chicken sandwich. The overall grilled and fried food preparations have not changed."

The audit report's conclusion that there have been no changes in Taxpayer's operations over the past decade is not supported by objective evidence, and Taxpayer has presented evidence contradicting this conclusion. Taxpayer presented evidence that electrical consumption has increased in these franchise restaurants over the past decade, as well as the volume of sales. Cooking procedures have changed for even common menu items, including the addition of equipment that did not exist a decade ago that utilizes higher energy consumption to prepare food. One such piece of equipment is a "clamshell grill" - used to prepare frozen hamburger patties, chicken patties, eggs and bacon - which heats food products from both the top and the bottom as opposed to a single surface grill. The clamshell grills also began utilizing Teflon surfaces in 2013, which requires higher grill temperatures and longer cooking times than a non-Teflon grill surface, and thus higher electricity consumption. The franchise has added menu items which have doubled the number of items cooked on the grill and quadrupled

the number of fried menu items over the past decade. Changes in cooking processes have also required an increase in electricity consumption, including a change from using partially cooked chicken to larger, raw chicken patties to improve quality. A chicken sandwich made in 2013 is *not* the same as a chicken sandwich a decade ago.

Taxpayer has also presented documentation showing that the Department's load factor calculations were understated for many pieces of equipment. The "load factor" is a key variable in determining the energy consumption of each piece of electrical equipment. Taxpayer provided information from equipment manufacturers showing the load factors for equipment currently being used by Taxpayer, which is the percentage of time the equipment is operating at full power. For example, the Department's load factor figure used for the grill equates to 2.9 hours of full power usage per day for each store. It is not logical or reasonable that a high volume fast-food restaurant open for 18 or 24 hours per day would only use its grills at full power for 2.9 hours per day. The equipment manufacturer uses a load factor of 0.30 to estimate typical function, which equates to 7.2 hours per day of full power usage, while Taxpayer calculated a more conservative load factor of 0.25, which equates to 6 hours of full power usage per day. Taxpayer demonstrated that equipment such as coffee makers, ice cream makers, orange juice machines, specialty coffee drink machines, commercial toasters, and heating cabinets are all utilized for more time (i.e. have a higher load factor) than what the Department accounted for in its comparison study.

The Department's comparison study also does not account for the same equipment used in Taxpayer's restaurants. The Department's study accounted for 6 fryers for one location when there were only 5 at Taxpayer's location. The Department also failed to account for the existence of a frozen dessert machine, a bun steamer, heated preparation tables, preparation coolers, an ice maker, and a microwave oven. Taxpayer provided photographs of these pieces of equipment, demonstrating that they were in fact present in the restaurants.

Taxpayer has demonstrated that the study used by the Department to recalculate Taxpayer's percentage of exempt usage is not an accurate reflection of Taxpayer's actual usage, particularly in light of changes made to Taxpayer's operations in the years since the study the Department relies upon was completed. A reasonable adjustment of the load factors of just two pieces of equipment - the clamshell grill and the toaster - would be sufficient to put Taxpayer's exempt utility usage over the 50 percent predominant use threshold. The audit erred by substituting its own calculations based on outdated data for the previously accepted utility studies provided by Taxpayer. Taxpayer has met is burden under IC § 6-8.1-5-1(c) of showing that the Department's assessment of additional use tax on utility purchases was wrong, and that it is entitled to the sought after exemptions for the tax years at issue.

FINDING

Taxpayer's protest is sustained.

Posted: 10/25/2017 by Legislative Services Agency
An html version of this document.