DEPARTMENT OF STATE REVENUE

Final Order Denying Refund:
04-20181313R; 04-20181314R; 04-20181315R; 04-20181316R; 04-20181317R; 04-20181318R; 04-20181319R; 04-20181320R; 04-20181321R; 04-20181322R; 04-20181323R; 04-20181324R; 04-20181325R; 04-20181326R; 04-20181327R; 04-20181328R; 04-20181336
Sales Tax
For the Years 2016 & 2017

NOTICE: IC § 4-22-7-7 permits the publication of this document in the Indiana Register. The publication of 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. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this document.

HOLDING

Indiana Restaurant Franchisee was not entitled to additional exemptions for gross retail tax on utility purchases because it failed to demonstrate that certain pieces of equipment were used in the production process and that the Department's utility studies were incorrect.

ISSUE

I. Sales Tax - Utility Exemption.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-2-1; IC § 6-2.5-5-5.1; IC § 6-2.5-5-3; IC § 6-2.5-4-1; IC § 6-2.5-1-27; *Indianapolis Fruit Co. v. Dep't of State Revenue*, 691 N.E.2d 1379 (Ind. Tax Ct. 1998); *Aztec Partners, LLC v. Indiana Dep't of State Revenue*, 35 N.E.3d 320 (Ind. Tax Ct. 2015); 45 IAC 2.2-2-1; 45 IAC 2.2-5-8; Sales Tax Information Bulletin 55 (May 2012).

Taxpayer seeks a refund of sales tax paid on electricity and gas utilities purchases.

STATEMENT OF FACTS

Taxpayers are two franchisees with common ownership that own and operate fast-food restaurants with seventeen locations in Indiana (for purposes of this decision, collectively referred to as "Taxpayer"). Each of Taxpayer's seventeen locations has one electric and one gas meter for a total of thirty-four meters. Taxpayer filed individual ST-200 forms and related GA-110L claim for refund forms for each location, claiming predominant use exemptions on all thirty-four meters. Upon review, the Indiana Department of Revenue ("Department") concluded that only two of the thirty-four meters met the predominant use requirement, and denied the refund claims for the remaining thirty-two meters.

Taxpayer protests those portions of their refund claims that were denied. An administrative hearing was held. This Final Order Denying Refund ensues. Additional facts will be provided as necessary.

I. Sales Tax - Utility Exemption.

DISCUSSION

Taxpayer purchases natural gas and electric utilities to power equipment in its restaurants such as fryers, food warmers, coolers, fountain drink systems, boilers, and microwave ovens. Taxpayer filed claims for refund based on its utility studies that determined it was entitled to full utility sales tax exemptions based upon predominant use in production. After reviewing Taxpayer's utility studies, the Department reduced the exempt percentage claimed for thirty-two of the meters and granted predominant use exemptions for one gas meter and one electric meter. The Department removed several pieces of equipment from the list of those used in the production process, including the "chub boiler," steam tables, refrigerator and microwaves. These pieces of equipment are utilized in preparing side dishes for customer consumption, which the auditor concluded is not "production" for purposes of the predominant use exemption.

Taxpayer disagrees, stating that the equipment in question is part of an integrated production process and should be included in the list of production equipment. Taxpayer also argues that the audit report did not utilize the correct load factors on certain pieces of equipment, including the front counter chicken warming compartments,

the chicken frying station warming compartments, French fry stations, fryer electric controls, fryer hood exhaust fans, and commercial toasters. Taxpayer also argues that the Department's gas utility study incorrectly calculates Taxpayer's gas usage.

Indiana imposes a sales tax on retail transactions made in Indiana. IC § 6-2.5-2-1(a); 45 IAC 2.2-2-1. A retail transaction is a transaction made by a retail merchant that constitutes "selling at retail." IC § 6-2.5-1-2(a). Selling at retail occurs when a person "(1) acquires tangible personal property for the purpose of resale; and (2) transfers that property to another person for consideration." IC § 6-2.5-4-1(b). Tangible personal property includes electricity and gas. IC § 6-2.5-1-27(2). A person who acquires tangible personal property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b).

Indiana law allows for certain sales tax exemptions. One such exemption is found under IC § 6-2.5-5-3(b):

> [T]ransactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property . . . .

Additionally, IC § 6-2.5-5-5.1(b) provides:

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it in 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.

Thus, in order to purchase electricity or gas exempt from sales tax, a taxpayer must directly consume the electricity or gas in the direct production of other tangible personal property. That is, the taxpayer must consume the electricity or gas to power machinery, tools, or equipment that is directly used in direct production.

Exemption statutes are strictly construed against the taxpayer. *Indianapolis Fruit Co. v. Dep't of State Revenue*, 691 N.E.2d 1379, 1383 (Ind. Tax Ct. 1998). Thus, "the taxpayer bears the burden of demonstrating entitlement to the exemption." *Id.* There is some guidance to taxpayers in demonstrating this entitlement. "To qualify for the exemption, the listed utility must be consumed as an essential and integral part of an integrated process that produces tangible personal property." Sales Tax Information Bulletin 55 (May 2012), 20120530 Ind. Reg. 045120251NRA. "In general, utilities will meet the test to the extent that they power equipment used as an essential and integral part of an integrated production process." *Id.* The Indiana Tax Court established a three-part test in determining whether a taxpayer qualifies for the utility exemption. According to the Indiana Tax Court, 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).

A. Production vs. Non-Production Equipment

Taxpayer argues that certain pieces of equipment used in the preparation of its side dishes should be classified as production equipment. Taxpayer claims that the sides have their own "unique integrated production process" that consists of heating and cooling the sides. Each of the side dishes–including green beans, mashed potatoes, rice and beans, and macaroni and cheese–arrive pre-cooked and frozen in large, transparent plastic packaging and stored in a walk-in freezer. As needed, the bags of frozen sides are removed from the freezer and flash thawed in a "chub boiler" for one to two hours. The sides are then microwaved to bring them to serving temperature. The sides are placed in bulk into individualized plastic pans and kept warm at serving temperature in heated steam tables. Upon customer order, individual servings are scooped out of the tray into individual serving cups with lids. Sides that are still in the bulk plastic pans at store closing time are placed in the refrigerator and refrigerated overnight. At opening the following day, the sides are microwaved to bring them back to serving temperature and returned to the steam tables. Taxpayer contends that the production process for side dishes starts with the flash thawing of the frozen, packaged side dishes; includes the microwave, steam tables, refrigerator, and reheating microwaves; and ends when the sides are placed into individual serving containers for service to customers.

To qualify for the utility exemption, Taxpayer must first be engaged in production. *Indianapolis Fruit Co.*, 691 N.E.2d at 1383. Generally, "production is 'defined broadly' and 'focuses on the creation of a marketable good.'" *Id.* (citing *Mid-America Energy Resources, Inc. v. Indiana Dep't of State Revenue*, 681 N.E.2d 259, 262 (Ind. Tax Ct.

1997)). Because the definition of production is so broad, "any evaluation of whether production is occurring depends on the factual circumstances of the case." *Id.* at 1384. 45 IAC 2.2-5-8(k) further explains that production is "an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a **substantial change**, and it must result in a transformation of property into a different product having a distinctive name, character and use." (**Emphasis added**). If production takes place, "[t]axpayers must demonstrate that the items they claim are exempt are integral and essential to that production." *Indianapolis Fruit Co.*, 691 N.E.2d at 1384. To make this determination, the points where production begins and ends are identified. *Id*. Production begins at the point of the first operation or activity constituting part of the integrated production process. 45 IAC 2.2-5-8(d). Production ends at the point that the production has altered the item to its completed form. *Id.*

The Indiana Tax Court has provided additional guidance regarding the production exemption as it relates to restaurants. In *Aztec Partners, LLC v. Indiana Dep't of State Revenue*, the LLC operated nineteen Qdoba restaurants in Indiana. 35 N.E. 3d at 322. Aztec employees prepared certain food items that were ultimately combined into entrees that were served to customers; employees used food warmers, hot food cabinets, a food bar with heating/cooling systems, walk-in coolers, and chip warmers to hold and preserve the prepared food before being ordered by customer. *Id*. Aztec requested a refund of the sales tax it paid on the electricity it used to power the electrical equipment. The Tax Court stated:

> "[T]here is one iron-clad rule: without production there can be no exemption.". . . "[W]hether production is occurring depends on the factual circumstances of [each] case." . . . In any event, production requires a "substantial" change or transformation resulting from "an integrated series of operations [that] places tangible personal property in a form, composition, or character different from that in which it was acquired." Although "production is 'defined broadly[,]' [it] 'focuses on the creation of a marketable good.'"
> . . .
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> "With respect to food items, this Court has held that a taxpayer is entitled to the equipment exemption when its equipment is directly used to induce a substantial chemical change in the food, thereby transforming the food into a new, marketable product." The Court has also held, however, that a wholesale supplier of fruits and vegetables is engaged in production when it cleans, cuts, and packages the fruits and vegetables for resale despite the lack of a chemical change in the fruits and vegetables.
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> Here, the parties have stipulated that Aztec's electrical "equipment ... hold[s] food items prepared by [Aztec] that will be combined into [the] entrées that are sold by [Aztec]." Accordingly, **Aztec's preparation and combination of the food items into entrées substantially changed the individual food items into new, marketable products that have a character and form different from the food items first acquired**. The Court, therefore, finds that Aztec was engaged in production during the period at issue.

Aztec, 35 N.E. 3d at 324 (**Emphasis added**).

The threshold issue to be determined is whether the equipment used in the preparation of side dishes is equipment used in an integrated production process. Without an integrated production process, there is no need to determine whether the equipment is "integral and essential" to such a process. The equipment at issue in Taxpayer's protest, unlike the equipment in *Aztec*, does not hold food items to be later combined "into new, marketable products that have a character and form different from the food items first acquired." *Id.* Taxpayer's use of the "chub boilers" and microwaves to thaw and warm the sides, the steam tables to keep the sides warm, and the refrigerators later used to store leftover sides, can be distinguished from the production process in *Aztec*. In *Aztec*, the food products in question were kept in a warming bins so that they could later be combined to make a single menu item; *i.e.* the production process had additional steps in order for the restaurant to serve a complete menu item.

In the instant protest, the production process for the side dishes is already complete prior to the sides arriving at the Taxpayer's restaurants. The production process for the side items ends at a previous location where they are packaged for delivery to Taxpayer's restaurant locations. Taxpayer merely warms these food items from their pre-cooked, frozen state, and places them into a container for service to the customer. The act of thawing and heating pre-cooked food alone does not create new, marketable products that have a different character and form, as contemplated by *Aztec*. The equipment at issue is not part of an integrated production process, as the side dishes are in substantially the same form when they are served as they are when the food arrives at Taxpayer's restaurants. Therefore, the Department was correct in excluding the "chub boiler," microwaves, steam tables, and refrigerators from the list of production equipment.

B. Equipment Utility Usage Calculations

Taxpayer also asserts that the Department erroneously calculated electricity usage by using incorrect load factors for the heated front counter chicken compartment, heater chicken compartment over the fryers, the electric controls for the gas fryers, the French fry station, the fryer hood exhaust fans, and the commercial toaster. Additionally, Taxpayer argues that the auditor erred in the calculation of gas usage for the tankless water heaters and gas fryers. During the auditor's review of one of Taxpayer's locations, she noted that some pieces of equipment included in Taxpayer's utility study were not working or plugged in or were used only on the weekends. During the site visit the auditor changed volts and amps for some of the equipment from what was stated by Taxpayer in its utility study to the actual information on the machines. No evidence was provided regarding whether all 17 locations used all of the equipment listed on Taxpayer's utility study.

Taxpayer provided a number of statements from individuals familiar with the restaurant equipment industry to support its argument that the Department relied upon erroneous information in calculating electricity and gas usage for the disputed equipment. Upon review, however, the Department is not able to agree that Taxpayer met its burden to demonstrate that the audit was incorrect. Specifically, Taxpayer did not provide verifiable source documentation to support its calculation of the "Load Factors." Taxpayer's "expert reports" consisted of Taxpayer's representative e-mailing Taxpayer's "experts" and providing them with his own interpretation of the usage calculations and merely asked these "experts" to confirm the information provided. With respect to the gas usage of the tankless water heaters, Taxpayer's representative told the expert what calculations to include in his opinion.

In addition, one of the expert opinions contradicts Taxpayer's statement regarding the location of the one restaurant that has heat-sensing controls on its exhaust fan, citing two different locations, and the load factor opined to for this piece of equipment is also inconsistent with Taxpayer's statement of protest. The expert states that the load factor for this particular exhaust fan is 50 percent while the statement of protest states that it is 60 percent. Further, Taxpayer's gas utility study spreadsheet uses a load factor of 1 for the gas fryers, while in its protest letter Taxpayer concludes that the fryers have a load factor of 33 percent. Taxpayer's expert explained that the gas burners of the fryers cycle on and off during both cooking and stand-by. This means that the fryers do not run at full power the entire time they are operating and therefore could not have a load factor of 1.

Finally, the spreadsheet provided by Taxpayer showing its proposed revisions to the Department's electricity study lists the total electricity usage for the electronic controls on the gas fryers as being 26,136 kilowatts, which is more than the electricity usage of the front counter heated chicken compartment, the fryer heated chicken compartment, fryer hood exhaust fan, and commercial toaster combined. The auditor previously noted that Taxpayer's annual electricity usage calculation for the electric controls exceeded the electricity usage of the air conditioning system. It does not make logical sense that an electronic display used to control the gas fryers would consume substantially more electricity that other pieces of equipment that solely run on electricity. Based upon these inconsistencies, the Department is not convinced that Taxpayer has demonstrated that these opinions are more reliable and accurate that the information utilized by the Department.

Without verifiable source documentation, the Department could not verify the information stated in the spreadsheet summary of Taxpayer's gas and electricity usage. Given the above examples of inconsistencies with Taxpayer's utility study and supporting documentation, the evidence provided to refute the auditor's conclusions is unreliable and does not meet Taxpayer's burden of showing that the auditor's usage calculations on the equipment in question was incorrect. Taxpayer has not demonstrated that equipment was improperly classified as non-production equipment, and has not shown that its utility study is more accurate than the Department's. Therefore, Taxpayer has not shown that it is entitled to the predominant use exemption for its purchase of electric and gas utilities.

FINDING

Taxpayer's protest is respectfully denied.

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