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6 of 18 DOCUMENTS

NAME: IN RE: * * *

NUMBER: HEARING NO. 41,113

COURT: COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS

CITE: 2002 *Tex. Tax LEXIS 151*

DATE: October 18, 2002

PANEL: [*1]

JACK M. WILHELM, Administrative Law Judge

COUNSEL: ELIAS V. LORENZANA, JR., Representing Administrative Hearings Section

* * *, * * *, Representing Petitioner

OPINIONBY: WILHELM

TAXPAYER NO.: * * *

AUDIT OFFICE: * * *

AUDIT PERIOD: 01/01/96 THROUGH 09/30/99

LIMITED SALES, EXCISE AND USE TAX/RDT

COMPTROLLER'S DECISION

PRELIMINARY DISCUSSION:

The Administrative Law Judge ("ALJ") heard this case at an oral hearing in * * *, Texas, on March 18, 2002. * * * and * * * represented Petitioner, and presented themselves as witnesses on Petitioner's behalf. Assistant General Counsel **Elias V. Lorenzana, Jr.** represented the Administrative Hearings Section, and presented the testimony of Cassandra Blanco, the auditor.

The ALJ took official notice of all records of the Comptroller's office that pertain to the Petitioner and the issues involved in the case. Unless otherwise indicated, all Section references are to Title 2, Texas Tax Code Ann. (Vernon 1992). References to Rules are to sections of Title 34, Texas Administrative Code.

On June 10, 2002, the Administrative Hearings Section filed Exceptions to the May 8, 2002 Proposed Comptroller's Decision. Petitioner filed its Response to these Exceptions [*2] on June 24, 2002. The ALJ and the Comptroller have considered the Administrative Hearings Section's Exceptions and the Petitioner's Response, and this Comptroller's Decision represents the ruling thereon.

CONTENTION OF PETITIONER:

Petitioner contends that its electricity purchases are tax-exempt because the electricity is used in the manufacturing or processing of tangible personal property for sale.

FINDINGS OF FACT:

1. Petitioner owns and operates a beef, pork, and poultry cold storage facility.

2. The Comptroller audited Petitioner for limited sales, excise, and use tax compliance for the period January 1, 1996, through September 30, 1999. On March 15, 2001, the Comptroller issued the Petitioner a Texas Notification of Audit Results, which included tax and interest through the date of the Notice. The Petitioner timely requested a redetermination hearing.

3. The auditor determined that no tax had been paid on electricity purchases. The auditor concluded that the taxpayer did not have an adequate utility study to establish Petitioner's predominant activity as processing, and, therefore, tax was due on these utility purchases.

4. Petitioner's predominant business [*3] activity is to receive poultry, at its facilities, that ranges in temperature from 36 [degrees] F to 24 [degrees] F. Petitioner further reduces the temperature of the received poultry products to the target temperature range of 7 [degrees] F to -7 [degrees] F, and then redelivers the poultry products, at its facility, to customers for ultimate sale and consumption in Mexico. Further freezing the chicken renders any bacteria inanimate. Once the temperature reduction process is completed, the customer seeks redelivery of this product as expeditiously as practicable, often the same day. The Petitioner charges its customers for reducing the temperature of the poultry, and for unloading and reloading the poultry. Absent one extraordinary circumstance, customers have not been and are not charged for storage.

5. According to the Food Safety and Inspection Service, United States Department of Agriculture (Exhibit 9), poultry maintained at 40 [degrees] F should be consumed within 1 to 2 days; poultry maintained at 0 [degree] F will be safe indefinitely. If the product at issue is not further frozen, but rather maintained at approximately 25 [degrees] F, it will spoil before it can be transported [*4] to the Mexican grocery stores where it is sold.

6. At the request of Petitioner, on March 3, 1999, * * *, Texas, prepared an Electric Predominant Use Study on Petitioner's operations. The study concluded that 64.98% of the electricity was used to process tangible personal property for sale in the regular course of business. (Exhibit 11). The study assumes 5 days to complete the freezing process and 2 days of subsequent storage. Among other things, the study contains the following:

- . Certified by * * *, licensed State of Texas Professional Engineer;
- . Certified by the president of Petitioner in front of the Administrative Law Judge;
- . 12 consecutive months of utility usage was included in the study; and
- . Listed all uses of the electricity, the times of usage, and the amount of energy consumed by each use, including:

- . Drink machine
- . Pay phone
- . PC system
- . Printer
- . Heater
- . Fax machine
- . Copier
- . Mini refrigerator
- . Warehouse compressor system (for reducing poultry to 0 [degree] F, plus or minus).

7. The testimony established that it takes 5 to 8 days, on average, to complete the temperature reduction process. As Petitioner explained through testimony and corroborating [*5] correspondence, the exact time it takes to freeze chicken is subject to several variables, including the following:

- . The temperature at which the chicken is received;
- . Compressor effectiveness;
- . Outside temperature; and
- . Outside humidity (Exhibits 8 and 16).

CONCLUSIONS OF LAW AND DISCUSSION:

Petitioner contends that its electricity purchases are tax-exempt because the electricity is used in the manufacturing or processing of tangible personal property for sale.

I recommend that Petitioner's contention be granted.

The AHS correctly points out that the burden of proof, by clear and convincing evidence, rests with the Petitioner. Rule 1.40(2)(A). Statutory exemptions are strictly construed. Exemptions are not raised by implication, and all doubts are resolved in favor of the taxing authority. *Bullock v. National Bancshares Corp.*, 584 S.W.2d 268 (Tex. 1979).

Petitioner contends that its electricity purchases are exempt pursuant to § 151.317(a)(2) because the electricity is predominantly used to power equipment exempt pursuant to § 151.318, commonly referred to as the manufacturing exemption.

Essentially, the argument against Petitioner revolves around the following [*6] issues:

1. That reducing the temperature of poultry from a range in temperature from 36 [degrees] F to 24 [degrees] F to a range of temperature of 7 [degrees] F to -7 [degrees] F, which such poultry is then sold for consumption in Mexico, is not an exempt manufacturing activity as defined by § 151.318; and
2. Even if the above activity is determined to be an exempt manufacturing activity, the utility study relied upon by Petitioner is deficient and fails to establish that Petitioner's predominant use of the electricity is reducing the temperature of the poultry from a range in temperature from 36 [degrees] F to 24 [degrees] F to a range of temperature of 7 [degrees] F to -7 [degrees] F.

Petitioner's activity of reducing the temperature of poultry from a range in temperature from 36 [degrees] F to 24 [degrees] F to a range of temperature of 7 [degrees] F to -7 [degrees] F, which such poultry is then sold for consumption in Mexico, is an exempt manufacturing activity as defined by § 151.318.

There is authority for the proposition that the lowering of temperature in food products to a target temperature causes a physical change and is an exempt manufacturing activity. [*7] Comptroller Decision Nos. 1,309 (1964) and 5,744 (1974). However, Comptroller decisions are clear that merely maintaining items at the desired temperature is not an exempt manufacturing activity. Comptroller Decision No. 7,378 (1976).

Finally, there is recent authority for the proposition that reducing the temperature of food products to merely satisfy the contractual requirement of the purchaser after packaging has occurred, and the target temperature already met, is not an exempt activity. Comptroller Decision Nos. 39,093 (2001), 39,807 (2001), 39,371 (2001), 39,486 (2001), and 39,542 (2002). However, such is not the case in this instance.

Here, the purpose of reduction of temperature of the poultry to approximately 0 [degree] F is necessary to establish a shelf-life sufficient for the product to be exported to Mexico, where it is ultimately sold and consumed. If the product is not further frozen, but rather maintained at approximately 25 [degrees] F, it will spoil before it can be transported to the Mexican grocery stores where it is sold (Finding of Fact No. 5). Poultry frozen to 0 [degree] F has an indefinite shelf-life, unlike poultry maintained at a higher temperature. This [*8] purposeful additional freezing constitutes a physical change and creates a product with an extended shelf-life, different from the product before this further freezing occurred that had a relatively short shelf-life of 1 to 2 days. This further freezing renders the bacteria in the chicken inanimate (Finding of Fact No. 4). Therefore, consistent with past Comptroller decisions, I conclude Petitioner's activity of reducing the temperature of poultry from a range in temperature from 36 [degrees] F to 24 [degrees] F to a targeted range of temperature of 7 [degrees] F to -7 [degrees] F, a necessary additional step for such poultry being sold for consumption in Mexico, is an exempt manufacturing activity as defined by § 151.318.

This analysis is consistent with Comptroller Decision No. 27,389 (1992). In that case, the Petitioner operated a business that accepted meat at a temperature between 15 [degrees] to 30 [degrees] F. Petitioner's business was to then further chill the meat to -2 [degrees] F; *this being done to render any bacteria inanimate*. Petitioner then redelivered this further frozen product to its customers. In that case, the Comptroller concluded that so long as electrical [*9] power was used to remove heat from packaged meat products down to the required target temperature of -2 [degrees] F, in order to render any bacteria inanimate, that action fell within the definition of processing. Notably, there was a purpose in further freezing the product -- it was a necessary additional step to render bacteria inanimate. Also, it is important to note that this case distinguished between freezers used by contractors solely to freeze meat, such as Petitioner's freezers in this proceeding, as opposed to freezers used by restaurants, which freeze and *maintain* meat. The inference of the decision is that restaurateurs would more logically be in the meat temperature "maintenance" business, at least to some degree.

Comptroller Decision No. 34,150 (1996) sheds further light on when product freezing can be determined a tax exempt manufacturing or processing activity for purposes of computing the tax on electricity consumption. In that case, the Petitioner received fresh and frozen seafood. Petitioner maintained the temperature of the fresh seafood and thawed the frozen seafood for repackaging. Petitioner then either sold the repackaged product or refroze the repackaged [*10]

product. Although the Comptroller concluded that some of Petitioner's activities could be properly classified as processing, the majority of the activities involved maintaining the fresh seafood and the unfrozen frozen seafood at constant temperatures, all being acts of maintenance as opposed to processing.

The utility study relied upon by Petitioner establishes that Petitioner's predominant use of the electricity is reducing the temperature of the poultry from a range in temperature from 36 [degrees] F to 24 [degrees] F to a range of temperature of 7 [degrees] F to -7 [degrees] F, a heretofore determined tax exempt activity for this Petitioner.

As correctly pointed out by the AHS, the act of maintaining the temperature of food after it has been lowered to the necessary temperature is not an exempt manufacturing activity. Comptroller Decision No. 7,378 (1976). The AHS argues the predominant use utility study relied upon by Petitioner fails to establish the tax exempt activity as the predominant use because -

- . It fails to disprove that the predominant activity of Petitioner's freezing compressors is the maintenance of the poultry at 0 [degree] F after the poultry has been [*11] reduced to that temperature.

Petitioner's predominant use utility study meets the regulatory requirements established by the Comptroller. Rule 3.295(f). See, Finding of Fact No. 6. The study establishes that a high percentage of the electricity consumption is for Petitioner's freezing compressors, with only incidental use supporting office equipment, such as the drink machine and fax machine.

The President of Petitioner testified that the business of Petitioner was reducing the temperature in chicken that is ultimately destined for Mexico for consumption. Absent one extraordinary event, Petitioner does not collect a fee for storage services, incidental or otherwise. The testimony established that it takes 5 to 8 days, on average, to complete the temperature reduction process. As Petitioner explained through testimony and correspondence, the exact time it takes to freeze chicken is subject to several variables, including the following:

- . The temperature at which the chicken is received;
- . Compressor effectiveness;
- . Outside temperature; and
- . Outside humidity (Exhibits 8 and 16) (Finding of Fact No. 7).

Once the temperature reduction process is completed, the customer seeks [*12] redelivery of this product as expeditiously as practicable, often the same day (Finding of Fact No. 4). Since Petitioner is not collecting a storage fee, there is no incentive for Petitioner to store the completed product. Since the customer will not make a financial return on the frozen chicken until delivered in Mexico, there is no incentive to leave the product in storage with Petitioner. Irrespective, in the interest of being conservative, Petitioner's predominant use study assumes 5 days to complete the freezing process and 2 days of subsequent storage (Finding of Fact No. 6). Even based on that conservative estimate, and taking into account the electricity usage of the miscellaneous office equipment (e.g., drink machine and fax machine), the predominant use of the electricity consumption is clearly for the reduction of temperature of chicken.

The AHS argues that the Petitioner has failed to establish that it takes 5 to 7 days to freeze chicken. Absent that fact being established, AHS argues, it arguably could have taken 1 to 2 days to freeze the chicken, and then it could have been stored, a non-tax exempt use, for up to 6 to 7 days. Under such a scenario, the predominant use [*13] of Petitioner's freezing compressors would be for maintenance, as opposed to tax exempt processing.

The testimony of Petitioner's President, as corroborated by the following, clearly establishes the predominant use being for reducing the temperature of chicken:

- . Petitioner does not collect a storage fee, so there is no economic incentive to offer that service;
- . Petitioner's customers have every incentive to remove the product from Petitioner as soon as the necessary reduced temperature is established;
- . Letters from several of Petitioner's customers establish these customers' understanding that it take 5 to 8 days for Petitioner to complete the freezing process that Petitioner offers for hire (Exhibit 8);
- . Excerpts from Petitioner's desk calendar establish that Petitioner's practice is to redeliver the product to customers within 6 to 8 days after initial delivery, consistent with the 5 to 8 days it takes to reduce the temperature (Exhibit 8); and
- . A representative of the engineering firm that performed the predominant use study clarified Petitioner's freezing process timeline, consistent with Petitioner's President's testimony (Exhibit 16).

Petitioner's predominant use [*14] study, as clarified by Petitioner's President's testimony that is corroborated by a number of sources, clearly and convincingly establishes that the predominant use of electricity by Petitioner is to support the processing of chicken, an exempt activity as determined above, pursuant to § 151.318.

RECOMMENDATION:

Based upon the findings of fact, conclusions of law, and discussion contained herein, the ALJ recommends that Exam 1 of the audit be adjusted to delete imposition of tax and interest on electricity purchases during the audit period.

SIGNED October 18, 2002.

ORDER OF THE COMPTROLLER

The above decision of the Administrative Law Judge is approved and adopted in all respects. This decision becomes final twenty-three (23) days from the date of this Order.

If a rehearing is desired, a Motion for Rehearing must be filed with the Administrative Law Judge no later than twenty-three (23) days after the date of this Order, and must state the grounds upon which the motion is based.

RENDERED and ISSUED October 18, 2002.

CAROLE KEETON RYLANDER, Comptroller of Public Accounts of the State of Texas

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