



STATE OF ARKANSAS
**Department of Finance
and Administration**

OFFICE OF THE DIRECTOR

1509 West Seventh Street, Suite 401
Post Office Box 3278
Little Rock, Arkansas 72203-3278
Phone: (501) 682-2242
Fax: (501) 682-1029
<http://www.dfa.arkansas.gov>

November 16, 2016

[REDACTED]

RE: IN THE MATTER OF [REDACTED]
Request for Revision
Audit ID: [REDACTED]
Docket Nos. 16-417 and 16-418

[REDACTED]:

This letter is in response to your September 5, 2016 request for a revision of the August 17, 2016 administrative decision issued in the above referenced matter. Specifically, you have requested a revision of the decision as it applies to the taxpayer's purchase of a tank car agitator and support, a dual bed nitrogen generator, steel drum heaters, and a boiler chemical (MPB-DC). You have also requested a revision of the decision as it applies to the assessment of penalties. Your letter is considered a timely filed request for revision in relation to the issues identified therein, and this response will constitute the final decision of the Department of Finance and Administration as to those issues under Ark. Code Ann. § 26-18-405.

FACTS

The taxpayer operates a food processing plant in Arkansas and produces products such as alfredo sauce, margarine or butter spreads, and marinara sauce. A review of the file in this matter reveals that a sales and use tax audit of the taxpayer's books and records was initiated in July 2014 for the reporting periods of January 1, 2009 through December 31, 2014. Prior to this audit, the taxpayer had not been previously audited. For purposes of this response, the audit revealed that the taxpayer failed to pay sales and use tax on various purchases which included the purchase of tangible personal property consisting of a tank car agitator and support, a dual bed nitrogen generator, steel drum heaters, and a boiler chemical (MPB-DC). Sales and use tax, interest, and penalty were assessed against the taxpayer in relation to these purchases.

During the course of the audit, the audit staff found that the taxpayer had provided exemption certificates to its in-state vendors during the audit period. At least some of these exemption certificates improperly claimed entitlement to exemption for otherwise taxable purchases. During the course of the audit, the taxpayer originally asserted that it had not provided its in-state

vendors with exemption certificates. However, these in-state vendors were able to, and did, provide the audit staff with copies of exemption certificates they received from the taxpayer. The auditor's review of those certificates revealed that the individual who claimed that exemption certificates had not been provided to in-state vendors was the same person who signed the exemption certificates.

During the course of the audit, the audit staff found that the taxpayer had failed to report and remit use tax on taxable purchases for a portion of the audit period. The taxpayer's accounting manager became aware of the requirement to report and remit use tax in 2012, and the taxpayer began reporting and remitting payment of use tax from that point forward, but failed to file amended returns to report use tax due for periods prior to the discovery of the requirement to report and remit use tax.

During the audit period, the taxpayer purchased a tank car agitator and support, a dual bed nitrogen generator, and steel drum heaters. These items were purchased by the taxpayer in relation to its production of margarine. Specifically, the margarine produced by the taxpayer is derived from a combination or recipe of raw ingredients, including palm oil and lecithin, which are mixed or blended together in a batch-wise process to produce margarine. The taxpayer did not pay sales and use tax on its purchase of these items.

The palm oil used in the taxpayer's margarine recipe is delivered to the taxpayer by rail car. The taxpayer's supplier of the oil blankets the oil in the rail car with nitrogen to prevent oxidation of the oil. During transport, the oil may partially or fully solidify and a steam heater is used to melt the solidified oil to assist with unloading of the oil. When the oil melts, the original identity of the oil is compromised or "fractured" with part of the oil being heavier and sinking to the bottom of the rail car and part of the oil being lighter and floating to the top of the rail car. The margarine produced by the taxpayer is supposed to be made out of one homogenous mixture of the two fractures of oil. The tank car agitator and support were purchased by the taxpayer to stir the fractured oil inside of the rail car to ensure a homogenous mixture of the oil and to ensure that all oil in the tank car is fully unloaded into holding tanks located at the taxpayer's facility. Prior to the purchase of the tank car agitator and support, some solidified oil would be left in the rail car and the oil offloaded into the taxpayer's holding tanks might not be the homogenous mixture required by the taxpayer's customers.

When the oil is unloaded from the tank car, oxygen will come into contact with the oil and cause oxidation of the oil. The oil received by rail car may not be immediately used by the taxpayer and could remain in the taxpayer's holding tanks for one day to one week. The oxidation of the oil that began when the rail car was unloaded can be reduced by storing the oil with nitrogen against the oil instead of oxygen, and the taxpayer purchased a nitrogen generator to produce nitrogen that will blanket the oil in the holding tanks in order to: (1) reduce oxidation that occurred when the oil was unloaded; (2) prevent oxidation that might occur when the oil is drawn from the holding tanks for introduction into the recipe used in producing a batch of

margarine; and (3) prevent spoilage of the oil before it can be introduced into a recipe for a batch of margarine.

Lecithin purchased by the taxpayer for use in a margarine recipe is delivered to the taxpayer in steel drums. The lecithin in a drum will be in a solid or a semi-solid state when it is delivered to the taxpayer. During the audit period, the taxpayer purchased steel drum heaters that are used to heat the steel drums and liquefy the lecithin before it is introduced into a recipe for a batch of margarine.

During the audit period, the taxpayer purchased certain boiler chemicals that were used to prevent scale build-up in the taxpayer's boilers, and thus preserve the heating efficiency of the taxpayer's boilers. In 2013, the taxpayer began a process called "culinary steam injection" which involves using "clean" steam to heat product produced by the taxpayer. This process also results in the steam becoming an ingredient in one or more of the taxpayer's products. Prior to adoption of the "culinary steam injection" process, the taxpayer purchased a boiler chemical that contained volatile compounds to prevent scale build-up in its boiler(s). These compounds would boil off and become part of the steam flowing through the taxpayer's steam system. With adoption of the "culinary steam process", the taxpayer began purchasing and using the chemical MPB-DC to prevent scale build-up in its boilers because MPB-DC contains non-volatile compounds that remain in the boiler and do not become part of the steam that will become an ingredient in the taxpayer's products.

In this case, the audit staff determined that the taxpayer's purchase of the tank car agitator and support, the dual bed nitrogen generator, the steel drum heaters, and the MPB-DC did not qualify for a tax exemption, and tax was assessed on the taxpayer's purchases of these items. In addition, the audit staff determined that an assessment of penalty was proper. The taxpayer protested this assessment. An administrative hearing was held on the taxpayer's protest and the hearing officer issued a decision sustaining the assessment. You have now requested a revision of the hearing officer's decision.

ANALYSIS

Tank Car Agitator and Support and Steel Drum Heaters

In regards to the taxpayer's purchase of the tank car agitator and support and the steel drum heaters, you assert that these items are exempt from tax as manufacturing machinery and equipment under Ark. Code Ann. § 26-52-402 (Repl. 2014 and Supp. 2015) and Arkansas Gross Receipts Tax Rule GR-55. The audit staff and the hearing officer determined that these items do not qualify for the claimed exemption because they are not used directly in manufacturing. Specifically, the hearing officer determined that the taxpayer's manufacturing of margarine begins when the taxpayer mixes or blends the raw materials together. Because the tank car agitator and support and the steel drum heaters are used prior to the mixing and blending of raw

materials, the hearing officer determined that these items are used prior to the start of manufacturing and thus did not qualify for exemption.

In your request for revision, you assert that the tank car agitator and support and the steel drum heaters are exempt from tax as new manufacturing machinery or equipment under GR-55(B)(2) because they: (1) “change” the raw material “in any essential respect” by changing them from a solid to a liquid; and (2) stir the raw material to maintain that changed state.

When a taxpayer claims to be entitled to a tax exemption, the statute providing the exemption must be construed in limitation of the exemption. *See* Ark. Code Ann. § 26-52-313 (Supp. 2015). There is a strong presumption in favor of the taxing power of the state, and all tax-exemption provisions must be strictly construed against the exemption. *Walther v. Carrothers Construction Co. of Arkansas, LLC*, 2016 Ark. 209, at 6, 492 S.W.3d 504, 507 (2016).

Arkansas Code Annotated § 26-52-402(a)(1) (Repl. 2014 and Supp. 2015) and GR-55 provide an exemption from tax for purchases of machinery and equipment that are used directly in manufacturing articles of commerce at manufacturing plants in this state.¹ In order to qualify for this exemption, the item must be:

1. Machinery or equipment;
2. Used in manufacturing;
3. Used directly in some stage of the manufacturing process at any time from the initial stage when actual manufacturing or processing begins through the completion of the finished article of commerce and the packaging of the finished end product²;
4. Used to manufacture an article of commerce; and
5. Used at a manufacturing or processing plant or facility in Arkansas.

Rineco Chemical Industries, Inc. v. Weiss, 344 Ark. 118, 126, 40 S.W.3d 257, 263 (2001).

In addition, the machinery or equipment must be purchased and used to create a new manufacturing or processing plant or facility in this state or to expand an existing manufacturing or processing plant or facility in this state. *See* Ark. Code Ann. § 26-52-402(a)(1)(B) (Supp. 2015).

Arkansas Code Annotated § 26-52-402(c)(2)(A)(iii) (Repl. 2014 and Supp. 2015) provides that machinery and equipment used in handling raw, semi-finished, or finished materials or property

¹ The exemption is actually available for purchases of machinery and equipment used directly in producing, manufacturing, fabricating, assembling, processing, finishing, or packaging articles of commerce at manufacturing or processing plants or facilities in the State of Arkansas. However, the exemption is summarized for purposes of this response.

² *See* Ark. Code Ann. § 26-52-402(c)(1)(A) (Repl. 2014 and Supp. 2015).

before the manufacturing process begins are not considered to be “used directly” in manufacturing for purposes of the exemption. In this case, the tank car agitator and support and the steel drum heaters are used in the handling of raw materials such as palm oil and lecithin that are later mixed or blended together into a recipe that produces batches of margarine. It is not disputed that the tank car agitator and support and the steel drum heaters change the state of the palm oil or lecithin from a solid or semi-solid state to a liquid state. However, the fact that a change to the state of the raw materials occurs is not sufficient to determine direct use for purposes of entitlement to the exemption. The United States Supreme Court and the Arkansas Supreme Court have recognized that manufacturing implies a change, but not every change is manufacturing. Instead, there must be a transformation and a new and different article must emerge that has a distinctive name, character, or use. *See East Texas Motor Freight Lines, Inc. v. Frozen Foods Express*, 351 U.S. 49 (1955) and *Ragland v. Arkansas Valley Coal Services, Inc.*, 275 Ark. 108, 627 S.W.2d 559 (1982). In this case, the palm oil and the lecithin begin the process of being transformed into the new and different article of margarine at the point where they are mixed or blended together with all other ingredients necessary to produce a batch of margarine. Accordingly, the hearing officer correctly determined that the tank car agitator and support and the steel drum heaters were used prior to the start of the manufacturing process and did not qualify for the claimed exemption.

Dual Bed Nitrogen Generator

In your request for revision, you have not clearly identified which tax exemption the taxpayer believes it is entitled to for the purchase of the dual bed nitrogen generator. However, you have cited Rule GR-55.1 and have asserted that the state has recognized that chemicals, catalysts, reagents, and solutions are exempt from tax.

Rule GR-55.1 was promulgated to implement and administer a statutory exemption under Ark. Code Ann. § 26-52-401(35) (Repl. 2014) for the sale of catalysts, chemicals, reagents, and solutions which are consumed or used in producing, manufacturing, fabricating, processing, or finishing articles of commerce at Arkansas manufacturing or processing plants or facilities. This exemption is available only for the sale of chemicals, catalysts, reagents, or solutions and does not extend to any machinery that might produce chemicals, catalysts, reagents, or solutions. Accordingly, to the extent the taxpayer is claiming that its purchase of the dual bed nitrogen generator is exempt from tax under Ark. Code Ann. § 26-52-401(35) (Repl. 2014) and Rule GR-55.1, the claim of exemption must be denied.

To the extent that you may be asserting that the dual bed nitrogen generator qualifies for exemption as manufacturing machinery and equipment, the claim must be denied for the same reasons the claim of exemption was denied for the tank car agitator and support and the steel drum heaters. The dual bed nitrogen generator is used to prevent raw materials, such as palm oil, from oxidizing or spoiling before it can be introduced into a recipe for a batch of margarine. Manufacturing of the margarine does not begin until there is a change that results in a new and different article, and it is not until the raw ingredients in a batch of margarine are blended

together that they lose their own identity and start to be transformed into the new article, *i.e.*, margarine. As the dual bed nitrogen generator is used in handling raw materials before those materials are mixed or blended together, it is not used directly in manufacturing for purposes of the manufacturing machinery and equipment exemption.

Boiler Chemical MPB-DC

In your request for revision, you have not clearly stated what tax exemption the taxpayer believes it is entitled to for the purchase of the boiler chemical MPB-DC. In fact, you have not identified any statute or rule that you believe would support a claim for exemption for the taxpayer's purchase of MPB-DC. However, testimony from the hearing and statements made in your request for revision indicate that you may be asserting the purchase of this chemical would be exempt as manufacturing equipment under Ark. Code Ann. § 26-52-402 (Repl. 2014 and Supp. 2015) or as chemicals, catalysts, reagents, and solutions used or consumed in manufacturing under Ark. Code Ann. § 26-52-401(35) (Repl. 2014).

To the extent that the taxpayer is claiming that the chemical is exempt manufacturing equipment under Ark. Code Ann. § 26-52-402 (Repl. 2014 and Supp. 2015) and Rule 55.1(D), the exemption must be denied because the chemical is being used to treat or maintain a boiler by preventing scale build-up. Arkansas Code Annotated § 26-52-402(c)(2)(C)(ii) (Repl. 2014 and Supp. 2015) specifically provides that machinery, equipment, and tools used in maintaining and repairing any type of machinery and equipment is *not* used directly in manufacturing for purposes of the manufacturing machinery and equipment exemption. Because a boiler is a machine, and the MPB-DC is maintaining the efficiency of the boiler by preventing scale build-up, the MPB-DC is not entitled to exemption as equipment because it is not used directly in manufacturing.

To the extent the taxpayer is claiming that the purchase of the MPB-DC qualifies for the exemption for chemicals, catalysts, reagents, and solutions under Ark. Code Ann. § 26-52-401(35)(A) (Repl. 2014) and Rule GR-55.1(C), the exemption must be denied. Specifically, Rule GR-55.1(C)(2)(c) provides that substances used to clean, protect, maintain, or otherwise affect machinery or equipment used in a manufacturing facility are not exempt and the MPB-DC purchased by the taxpayer is clearly being used to protect and maintain the taxpayer's machinery by preventing scale build-up.

Penalty

You have challenged the assessment of penalty for two reasons. First, you have asserted that the assessment of penalty in relation to the use tax portion of the assessment violates Department policy as set forth in Example 2 on Page 259 of the Department's Field Audit Manual. Second, you have alleged that the assessment of penalty in relation to the sales tax portion of the assessment violates Department policy as set forth in Example 5 on Page 260 of the

Department's Field Audit Manual. Specifically, you assert the Department has not proven the taxpayer was negligent for purposes of the assessment of penalty.

In this case, the Department assessed a negligence penalty for both the sales tax and use tax portions of the audit at issue in this matter. Specifically, the taxpayer was assessed penalty under Ark. Code Ann. § 26-18-208(4)(A), which provides as follows:

(4)(A) If any part of a deficiency in taxes is determined to be due to negligence or intentional disregard of rules and regulations promulgated under the authority of this subchapter or any state tax law, then the director *shall add a penalty* of ten percent (10%) of the total amount of the deficiency in addition to any interest provided by law. (Emphasis added).

The term "negligence" is not defined within Ark. Code Ann. § 26-18-101 *et seq.* (Repl. 2012). However, Black's Law Dictionary defines negligence to include an "omission to do something which a reasonable man, guided by those considerations which ordinarily regulate the conduct of human affairs, would do." *See* Black's Law Dictionary Free Online Legal Dictionary 2nd Ed. In addition, the Merriam-Webster Online Dictionary defines negligence to be a "lack of normal care or attention".

Example 2 on Page 259 of the Department's Field Audit Manual provides that no penalty is to be assessed if a manufacturing firm has never been audited and the corporation's accountant has no knowledge of compensating use tax. In this case, the evidence established that the taxpayer had not undergone a previous use tax audit. The evidence has also established that: (1) the taxpayer learned of the requirement to report and pay use tax before the audit was initiated; (2) the taxpayer began reporting and remitting use tax in 2012; and (3) the taxpayer failed to review its books and records and amend previously filed returns to report use tax that was due for earlier periods. Because the taxpayer had knowledge of the requirement to report and pay use tax at the time of the audit but failed to amend returns to report and pay that tax for earlier periods, the policy set forth in Example 2 on Page 259 of the Department's Field Audit Manual would not apply. The assessment of penalty did not violate the Department policy set forth in Example 2 on Page 259.

Example 5 on page 260 of the Department's Field Audit Manual also pertains to the application of penalty for use tax audits. In this example, the manual provides that a 10% penalty will apply if it is factually determined that a specific act of negligence or intentional disregard occurred where a manufacturer is registered for use tax, reports use tax for the first six months but later stops reporting the tax, and additional taxable purchases are found for both the six month time in which tax was reported and for the months after the manufacturer stopped reporting use tax. In this case, the evidence has established that: (1) the taxpayer provided in-state vendors with exemption certificates; (2) the taxpayer advised the audit staff that it had not provided its in-state vendors with exemption certificates; (3) the audit staff was able to determine that the taxpayer did provide exemption certificates to its in-state vendors and the person who signed those

exemption certificates was the person who informed the auditors that exemption certificates had not been provided to the in-state vendors; (4) certain purchases from the in-state vendors did not qualify for a tax exemption and the taxpayer did not report and pay tax on those purchases; and (5) the person who signed the exemption certificates was promoted to plant controller and he began revoking the exemption certificates but did not necessarily amend previously filed reports to report and pay sales tax on the purchases from in-state vendors that did not qualify for exemption. The fact scenario at issue in this case is very different than the fact scenario in Example 5 on Page 260 of the audit manual. However, this case demonstrates that the taxpayer provided its in-state vendors exemption certificates for purchases that were not eligible for exemption and then failed to report and remit tax on those purchases at the time the items were withdrawn from stock. Such facts demonstrate negligence or lack of normal care and attention. Therefore, for purposes of assessing penalty in relation to the sales tax portion of the assessment, the decision of the hearing officer is sustained.

CONCLUSION

For the reasons set forth in this response, the decision of the hearing officer is sustained in full. This concludes your administrative remedies under the Tax Procedure Act. Judicial relief from this decision may be sought according to the procedure set forth in Ark. Code Ann. § 26-18-406 (Repl. 2012).

Sincerely,

Tim Leathers
Deputy Director and
Commissioner of Revenue