

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION SUMMARY FOR BOARD HEARING

3 In the Matter of the Petition for)
 4 Redetermination and Claim for Refund)
 4 Under the Sales and Use Tax Law of:) Account Number: SR ARH 100-063547
 5 GRIMMWAY ENTERPRISES, INC.) Case ID's 379965, 379508
 6 Petitioner/Claimant) Shafter, Kern County

7 Type of Business: Farming
 8 Audit period: 01/01/02 – 12/31/04
 9 Claim period: 01/01/02 – 12/31/02

10 <u>Item</u>	<u>Disputed Amount</u>
11 Disallowed claimed partial exemption for	
11 purchases of farm equipment machinery	\$40,673,145
12 Claimed overpayment on amnesty returns	unstated ¹
12 Tax as established by audit and protested:	\$1,981,194.04 ²
13 Reported on amnesty returns	- 481,047.00
14 Tax as determined	<u>\$1,500,147.04</u>
15 Proposed tax determination	\$1,500,147.04
15 Interest through 9/30/06 (tax paid in full 9/8/06)	<u>265,028.43</u>
16 Total tax and interest	\$1,765,175.47
16 Payments	<u>-1,765,175.47</u>
17 Balance Due	<u>\$ 0.00</u>

18 This matter was previously scheduled for Board hearing in Culver City on June 17, 2010, but
 19 petitioner requested that it be rescheduled and heard in Sacramento. This matter was then scheduled
 20 for Board hearing on July 15, 2010, but petitioner requested postponement to allow it additional time
 21 to submit an opening brief.

23 ¹ Petitioner reported tax of \$481,047.00 on amnesty returns and paid the total amount of tax, plus interest, on May 27, 2005.
 24 The Notice of Determination was then issued for \$1,500,147.04, the difference between the understatement of tax
 25 established by audit and the amount reported on amnesty returns. Petitioner filed a claim for refund on March 10, 2006, of
 26 amounts paid on amnesty returns. In general, the claim would not be timely for the amounts reported on amnesty returns
 27 because it was filed more than three years after the due-dates of the returns for all quarters of 2002 and more than six
 28 months after the date of payment. However the amount reported on the amnesty returns was established in an audit and
 would have been included in the determination if petitioner had not filed amnesty returns. Under these circumstances, in
 order to avoid any harm to petitioner's appeal rights as a result of amnesty, we regard the claim as filed with respect to a
 determination, and find it is timely because it was filed before the determination became final.

² The audited understatement of tax is based on a measure of \$39,873,727, which represents the disallowed partial
 exemption with respect to purchases totaling \$40,673,145, net of various credits that are not protested.

UNRESOLVED ISSUE

1
2 **Issue:** Whether adjustments are warranted to the disallowed claimed partial exemptions for
3 purchases of farm equipment and machinery. We recommend no adjustments.

4 Petitioner operates a farming business that produces, processes, and ships vegetables. It grows
5 and processes its own vegetables (primarily carrots) and packs citrus for other farmers. In addition,
6 petitioner has agreements with other farmers who grow vegetables on petitioner's behalf. The largest
7 of petitioner's processing facilities processes carrots into baby carrots, while others are facilities for
8 juicing and processing frozen vegetables. All of petitioner's sales of vegetables qualify as exempt
9 sales of food products or nontaxable sales for resale. Petitioner's only taxable sales consist of sales of
10 fixed assets and some sales of company apparel, which petitioner reported. The transactions at issue
11 here are partial exemptions from tax that petitioner claimed with respect to purchases of farm
12 equipment. (Rev. & Tax. Code § 6356.5, subd. (a); Cal. Code Regs., tit 18, § 1533.1.)

13 During the audit, the Department found that petitioner had claimed partial exemptions with
14 respect to equipment and machinery that did not qualify under the statute and regulations. In a
15 memorandum dated November 2, 2005, the Board's Tax Policy Division stated that, to qualify for the
16 partial exemption, farming equipment and machinery must be used in producing and harvesting
17 agricultural products as described in Major Groups 01, 02, and 07 of the Standard Industrial
18 Classification (SIC) Manual. The memorandum also states that, except as otherwise provided under
19 those groups, producing and harvesting activities do not include post-harvesting activities or activities
20 described or designated in Major Group 20 of the SIC Manual. Using this memorandum as guidance,
21 the Department disallowed claimed partial exemptions with respect to: 1) purchases of assets from out-
22 of-state vendors of \$579,058 (examined on an actual basis); 2) purchases of assets from California
23 vendors of \$2,401,415 (examined on an actual basis); 3) purchases of consumable expense items of
24 \$32,875,739 for which petitioner had accrued no use tax, excluding purchases from Motion Industries
25 (examined on a statistical basis); 4) purchases of consumable expense items for which petitioner had
26 accrued some use tax, but less than the amount due, of \$3,188,038, excluding purchases from Motion
27 Industries (examined on a statistical basis); and 5) purchases from Motion Industries of \$1,628,895
28 (examined on an actual basis).

1 Petitioner does not dispute the audit methodology. It disputes the classification of some of the
2 farm equipment and machinery tested. Specifically, petitioner contends that its farm equipment and
3 machinery used to manufacture baby carrots that cut, peel, grind, and polish carrots should be
4 classified under SIC Code 0723 (Crop Preparation Services for Market, Except Cotton Ginning).
5 Petitioner asserts that these activities do not fall under SIC Code 2099 (Food Preparations, Not
6 Elsewhere Classified) because major Group 20 SIC Codes are for processed or manufactured foods,
7 not fresh foods. Petitioner further states that, although SIC Code 2099 lists the example of
8 “Vegetables peeled for the trade,” this example refers to businesses that provide peeling services for
9 others and does not include the activities in question. Similarly, petitioner disputes the Department’s
10 finding that the equipment used to store and precool the carrots and the forklifts that unload incoming
11 vegetables or citrus do not qualify for the partial exemption

12 As relevant here, Revenue and Taxation Code section 6356.6, subdivision (a), partially exempts
13 from the use tax the storage and use of farm equipment and machinery, and the parts thereof,
14 purchased for use by a qualified person to be used primarily in producing and harvesting agricultural
15 products. “Producing and harvesting agricultural products” includes those activities described in
16 Major Groups 01, 02, and 07 of the SIC Manual. (Cal. Code Regs., tit. 18, § 1533.1, subd. (b)(5).)
17 Except as otherwise provided under Major Groups 01, 02, or 07 of the SIC Manual, producing and
18 harvesting activities do not include post-harvesting activities nor those activities described or
19 designated in Major Group 20 of the SIC Manual.

20 Regarding the equipment used in cutting, peeling, grinding, and polishing carrots, petitioner
21 contends that these activities are similar to those included under SIC Code 0723, such as bean
22 cleaning, corn shelling, grain grinding, nut hulling and shelling, and packaging fresh or farm-dried
23 fruits and vegetables. We note that Major Group 07 of the SIC Manual consists, in relevant part, of
24 establishments primarily engaged in performing soil preparation services, crop services, farm labor,
25 and management services *for others on a contract or fee basis*. Here, petitioner has stated that it is a
26 farming operation that is not providing a service for others. Thus, we conclude that the farming
27 equipment and machinery at issue here cannot be categorized under Major Group 07. Further,
28 petitioner likens the process of cutting and preparing the baby carrots to grinding grain, which is listed

1 under SIC Code 0723. We find that grain grinding is not similar to slicing or cutting an object to a
2 desired size because grain grinding primarily involves a pressure and friction process, rather than
3 cutting. We also disagree with petitioner's assertion that SIC Code 2099, cited by the Department,
4 relates only to processed or manufactured foods. SIC Code 2099 includes the preparation and
5 processing of fresh products such as vegetables peeled for the trade and salads that are fresh or
6 refrigerated. The processing of those products involves peeling and cutting, the same activities at issue
7 here. We further find that "peeled for the trade" does not refer to peeling as a service for others, as
8 argued by petitioner. If that were the case, then vegetables and potatoes peeled for the trade would
9 have been categorized under major Group 07, which specifically refers to services performed for
10 others. In addition, we have reviewed the North American Industry Classification System (NAICS),
11 which was developed to replace the SIC system. We note that NAICS Code 311911 includes food
12 preparation processes other than a mechanical or chemical transformation, and includes the cutting and
13 peeling of carrots. Further, NAICS Code section 31911 indicates that these activities would have been
14 included under SIC Code 2099. Therefore, the NAICS Code lends strong support to our conclusion
15 that the activities of creating a baby carrot fall under SIC Code 2099. Finally, while neither SIC Code
16 0723 nor 2099 specifically addresses the process of producing baby carrots, Regulation 1533.1,
17 subdivision (b)(5), states that, except as otherwise provided under Major Groups 01, 02, and 07 of the
18 SIC Manual, producing and harvesting activities do not include post-harvesting activities. Therefore,
19 even if it were determined that the activities involved in producing baby carrots should not be
20 classified under SIC Code 2099, they are post-harvesting activities that do not qualify for the
21 exemption.

22 Also in dispute is equipment used to precool carrots and to store and ship the packaged baby
23 carrots. Regulation 1533.1, subdivision (b)(1)(A), states that equipment used to store vegetables
24 qualifies for the partial exemption, only if that equipment is used as part of a qualified activity.
25 Shelving used to store packaged or processed products does not qualify for the partial exemption
26 because that shelving is used in a post-harvesting activity. Thus, the equipment at issue here, which
27 was used for storing and shipping packaged vegetables, does not qualify for the partial exemption.
28

1 Another type of equipment at issue is forklifts petitioner used to unload incoming vegetables
2 from the field, to move products throughout its processing plants, to move packaged vegetables in
3 storage areas, and to load packaged vegetables in shipping areas. In order for a vehicle, such as a
4 forklift, to qualify for the partial exemption, Regulation 1533.1, subdivision (b)(1)(B), requires that the
5 vehicle be designated as an implement of husbandry by the California Vehicle Code, and that it be
6 used exclusively in the conduct of agricultural operations. We conclude that the forklifts do not
7 qualify for the partial exemption because they were not used *exclusively* for agricultural operations.

8 **AMNESTY/RESOLVED ISSUE**

9 The D&R recommends relief of the amnesty interest penalty. Petitioner filed an application for
10 amnesty, reporting the amount of amnesty-eligible liability estimated by the Department. Petitioner
11 paid the total amount of tax and interest reported on amnesty returns prior to March 31, 2005.
12 Subsequently, the Department requested guidance from the Board's Tax Policy Division, which issued
13 a memorandum dated November 2, 2005. Based on the direction in that memorandum, the Department
14 disallowed claimed partial exemptions for farm equipment that it had allowed when it established the
15 estimated amount petitioner reported on amnesty returns. Since petitioner did not report the entire
16 amount due for the amnesty-eligible period, the amnesty interest penalty would have been imposed
17 with respect to the difference between the Department's estimate and the amount established by audit.
18 Petitioner filed a request for relief of the amnesty interest penalty on the grounds that it made full and
19 reasonable attempts to pay the 2002 liability in a timely manner. The D&R notes that the provisions
20 regarding partial exemptions for farm equipment are complex and finds that petitioner's failure to pay
21 the tax and interest with respect to the increased amount of the liability was due to reasonable cause
22 and circumstances beyond petitioner's control. On that basis, the D&R recommends relief of the
23 amnesty interest penalty.

24 **OTHER DEVELOPMENTS**

25 None.

26
27 Summary prepared by Rey Obligacion, Retired Annuitant
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Statistical Sample

Transactions Examined	Purchases of expense items subject to use tax
Confidence level	80%
Confidence interval	7.11%
Total number of items in the population	113,418
Number of items randomly selected for the test	2,073
Number of errors found	732
Whether stratification was used, and if so what was stratified	Yes *
Average dollar value of population	Stratum 1 - \$536 Stratum 2 - \$5,308 Stratum 3 - \$122,715 Stratum 4 - \$1,473 Stratum 5 - \$17,755
Dollar value of remaining errors (all strata combined)	\$3,885.980
Dollar value of sample (all strata combined)	\$43,793,331
Percentage of error	8.87%

* Expenses for which petitioner had not accrued any use tax liability—Stratified in amounts \$100-\$2,000, \$2,000-\$30,000, and greater than \$30,000.
Expenses for which petitioner had accrued use tax liability, but not the correct amount—Stratified in amounts \$300-\$6,000 and greater than \$6,000