

DECISION OF MUNICIPAL TAX HEARING OFFICER

November 21, 2011

Taxpayer

Attn: ***Taxpayer's Representative***

Taxpayer's Address

Phoenix, AZ 85083-9096

Taxpayer

MTHO # 626

Dear Taxpayer:

We have reviewed the evidence and arguments presented by ***Taxpayer*** and the City of Phoenix (Tax Collector or City) at the hearing on August 1, 2011 and in post-hearing memoranda. The review period covered was March 2005 through November 2008. Taxpayer's protest, Tax Collector's response and our findings and ruling follow.

Taxpayer's Protest

Taxpayer operates grocery stores with in-house bakery and meat departments. During the review period, Taxpayer purchased equipment for use in its bakery and meat departments without paying a privilege or use tax. The Tax Collector concluded that Taxpayer was liable for use tax when it purchased the equipment. The Tax Collector erred in concluding that Taxpayer's purchases were subject to the City use tax. The equipment used in Taxpayer's bakery and meat departments constitute exempt income producing capital equipment. Taxpayer's purchase of the equipment was therefore not subject to the City use tax.

Tax Collector's Response

Taxpayer operates grocery stores. The exemption for income producing capital equipment was intended to include businesses engaged in what are normally thought of as manufacturing operations. A grocery store with a bakery and a meat department is not engaged in manufacturing, as that term is commonly understood. Taxpayer's purchase of the equipment was subject to the City use tax.

Discussion

Taxpayer operates grocery stores within the City. The stores have a bakery and a meat department where Taxpayer prepares some of the items it sells. The Tax Collector audited Taxpayer for the period March 2005 through November 2008 and determined that Taxpayer had not paid a City use tax on equipment it purchased for use in its bakery and meat departments. Taxpayer protested contending the equipment was exempt income producing capital equipment.

Phoenix City Code (PCC) § 14-610 imposes a use tax on the storage or use of tangible personal property in the City. PCC § 14-660 exempts income producing capital equipment from the use tax. The only issue presented is whether Taxpayer's purchase of equipment for its bakery and meat departments was exempt under PCC § 14-660.

Income producing capital equipment is defined in PCC § 110(a)(1) as:

machinery or equipment used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations. The terms "**manufacturing**", "**processing**", "fabricating", "job printing", "refining", and "metallurgical" as used in this paragraph refer to and **include those operations commonly understood within their ordinary meaning**. "Metallurgical operations" includes leaching, milling, precipitating, smelting and refining. (Emphasis added)

State statutes impose a transaction privilege tax on the business of selling tangible personal property in the state. The Tax Collector relies primarily on the Arizona Court of Appeals' decision in *Ariz. Dep't of Revenue v. Blue Line Distrib., Inc.*, 202 Ariz. 266, 43 P.3d 214 (App. 2002) to argue that Taxpayer was not engaged in manufacturing and was therefore not entitled to the exemption provided by PCC § 14-660.

The question in *Blue Line* was whether sales of kitchen equipment to a pizzeria, such as an industrial dough mixer, are exempt from the Arizona transaction privilege tax as equipment used in a "manufacturing" or "processing" operation. A.R.S. § 42-5061(B)(1) allowed a deduction for:

Machinery, or equipment, used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations. The terms "**manufacturing**", "**processing**", "fabricating", "job printing", "refining" and "metallurgical" as used in this paragraph refer to and **include those operations commonly understood within their ordinary meaning**. "Metallurgical operations" includes leaching, milling, precipitating, smelting and refining. (Emphasis added)

Directly used in manufacturing or processing was interpreted by *Blue Line* to include the requirement that the manufacturing be performed by manufacturers such as commercial glassworks, sausage makers, grain mills, leather goods factories, slaughterhouses, tanneries, and the like. The holding in *Blue Line* was that as a matter of law a restaurant was not a manufacturer or a processor within the commonly understood meaning of those terms.

In identifying the equipment that may be exempt from a privilege or compensating use tax, both the state and the City have the same definition. *Blue Line* specifically addressed the state definition. The question thus boils down to whether *Blue Line* is applicable, and if it is, whether a grocery store with a bakery and a meat department is like a commercial glassworks, sausage maker, leather goods factory or slaughterhouse.

Blue Line relied in part on an administrative interpretation by a department of revenue rule that exempt manufacturing is the performance as a business of an integrated series of operations that transform personal property into a different product. Even though the City does not itself have a similar administrative interpretation, the City code provides that when the state statutes and model city tax code are the same and where the department of revenue has issued written guidance, the department's interpretation is binding on cities and towns. Therefore the holding in *Blue Line* applies here.

Given the Court's decision in *Blue Line*, we hold that Taxpayer's grocery store business is not like a commonly understood manufacturing business such as commercial glassworks, sausage maker, leather goods factory or slaughterhouse. The examples listed by the court had the common theme of businesses that primarily engage in manufacturing a product. Taxpayer's primary business is

retail grocery sales. Tax exemption and deduction statutes are strictly construed against the exemption. Construing PCC § 14-660 strictly against the exemption, we conclude that Taxpayer's purchase of the equipment was not exempt from the City's use tax. The Tax Collector's assessment was proper.

Findings of Fact

1. Taxpayer operates grocery stores selling grocery items within the City.
2. Taxpayer's stores include bakery and meat departments where it prepares baked goods and meat products for sale to its grocery customers.
3. Taxpayer utilizes equipment such as oven racks, oven proofers and meat grinders in its bakery and meat departments.
4. Taxpayer purchased equipment for use in its bakery and meat departments without paying the City use tax.
5. The Tax Collector conducted an audit of Taxpayer for the period March 2005 through November 2008 and concluded that Taxpayer's purchase of the equipment was subject to the City use tax.
6. Taxpayer timely protested the assessment contending that the equipment it purchased for use in its bakery and meat departments constituted exempt income producing capital equipment.

Conclusions of Law

1. PCC § 14-610 imposes a use tax on the storage or use of tangible personal property in the City.
2. PCC § 14-660 exempts income producing capital equipment from the use tax.
3. Income producing capital equipment is defined in PCC § 110(a)(1) as:

machinery or equipment used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations. The terms "manufacturing", "processing", "fabricating", "job printing", "refining", and "metallurgical" as used in this paragraph refer to and include those operations commonly understood within their ordinary meaning. "Metallurgical operations" includes leaching, milling, precipitating, smelting and refining.
4. The state of Arizona imposes a transaction privilege tax on the sale of tangible personal property within the state. A.R.S. § 42-5061.
5. A.R.S. § 42-5061(B)(1) allows a deduction from the state tax for:

Machinery, or equipment, used directly in manufacturing, processing, fabricating, job printing, refining or metallurgical operations. The terms "manufacturing", "processing", "fabricating", "job printing", "refining" and "metallurgical" as used in this paragraph refer to and include those operations commonly understood within their ordinary

meaning. "Metallurgical operations" includes leaching, milling, precipitating, smelting and refining.

6. When the state statutes and model city tax code are the same and where the department of revenue has issued written guidance, the department's interpretation is binding on cities and towns. A.R.S. § 42-6005.D.; PCC § 14-500(e)(2).
7. The department of revenue has interpreted the term manufacturing in A.R.S. § 42-5061(B)(1) as the performance as a business of an integrated series of operations that transform personal property into a different product. A.A.C. R15-5-120(A).
8. Tax deductions and exemptions are to be strictly construed against the deduction or exemption. *Arizona Department of Revenue v. Raby*, 204 Ariz. 509, 511, 65 P.3d 458 (App. 2002).
9. Taxpayer has the burden to show he is entitled to an exemption or deduction from taxation. *Ebasco Servs., Inc. v. Ariz. State Tax Comm'n*, 105 Ariz. 94, 99, 459 P.2d 719, 724 (1969).
10. A grocery store business containing bakery and meat departments is not a manufacturer as that term is used in PCC § 110(a)(1). *Ariz. Dep't of Revenue v. Blue Line Distrib., Inc.*, 202 Ariz. 266, 43 P.3d 214 (App. 2002).
11. Taxpayer's purchase of the equipment for use in its bakery and meat departments was not exempt from the City's use tax. PCC § 110(a)(1).
12. The City's use tax assessment against Taxpayer was proper.

Ruling

Taxpayer's protest of the City's use tax assessment for the period March 2005 through November 2008 is denied.

The Tax Collector's Notice of Assessment to Taxpayer for the period March 2005 through November 2008 is upheld.

The parties have timely rights of appeal to the Arizona Tax Court pursuant to Model City Tax Code Section -575.

Sincerely,

Hearing Officer

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c: **Deputy Finance Director**
Municipal Tax Hearing Office