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WV SECRETARY OF STATE
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REDACTED DECISION – DK# 21-169

BY: A.M. "FENWAY" POLLACK, CHIEF ADMINISTRATIVE LAW JUDGE
SUBMITTED FOR DECISION ON JANUARY 31, 2023
ISSUED ON DECEMBER JUNE 22, 2023

NOTE: THIS ADMINISTRATIVE DECISION WAS APPEALED BEYOND THE OFFICE OF TAX APPEALS

FINAL DECISION

On August 25, 2021, the Auditing Division of the West Virginia State Tax Department (the "Tax Commissioner" or "Respondent") issued an Audit Notice of Assessment against the Petitioner. This assessment was issued pursuant to the authority of the State Tax Commissioner, granted to him by the provisions of Chapter 11, Article 10 *et seq*, of the West Virginia Code. The assessment was for combined sales and use tax for the period January 1, 2018, through March 31, 2021, for tax in the amount of $xxx,xxx.xx, interest in the amount of $ xx,xxx.xx, and additions to tax in the amount of $ xx,xxx.xx, for a total assessed tax liability of $ xxx,xxx.xx.

Thereafter, on October 15, 2021, the Petitioner timely filed with this Tribunal, the West Virginia Office of Tax Appeals, a petition for appeal. *See* W. Va. Code Ann. §§ 11-10A-8(1); 11-10A-9 (West 2010).

Subsequently, notice of a hearing on the petition was sent to the Petitioner, and, in accordance with the provisions of West Virginia Code Section 11-10A-10, a hearing was held on September 8, 2022, after which the parties filed legal briefs. The matter became ripe for decision at the conclusion of the briefing schedule.

FINDINGS OF FACT

1. The Petitioner is a West Virginia S corporation, incorporated in 1946. Its principal place of business is County A, West Virginia. The Petitioner engages in numerous business activities, including highway commercial construction, site development for the oil and gas

industry, construction and installation work for municipalities and public service districts, and it is the seller of aggregates and asphalt. Tr. P30 at 9-22.

2. Regarding the Petitioner's production of natural resources, namely limestone, it uses three (3) different types of trucks. First, are the trucks which haul the newly quarried limestone from the pit floor to a piece of equipment called a crusher. These trucks can haul 50-75 tons at a time. Once the limestone is done at the crusher, it is hauled by smaller trucks to the Petitioner's stockpile. Once the limestone is sold and leaves the Petitioner's quarry it is transported on a third type of truck suitable for travel on the highways. Tr. P29 at 14-22.

3. Regarding the Petitioner's work for municipalities and public service districts, the Petitioner bids on these jobs, and the work consists almost exclusively of digging ditches, laying the necessary piping, filling the trenches with the appropriate fill material, and some manhole installation. Tr. P32 at 7-23.

4. Sometime, in 2014, the Petitioner was audited by the West Virginia Tax Department regarding tax years 2011 through 2013. At the conclusion of that audit, the Petitioner was informed that it was calculating its sales and use tax remittances incorrectly. The Petitioner was told that going forward it should take the equipment it purchased for repairs and maintenance on PSD/municipality jobs and apportion it, based upon how much time that equipment was used on "exempt" jobs versus non-exempt jobs. Going forward the Petitioner did just that. Tr. P45 at 5-9 & Tr. P56-57 at 17-21.

5. In 2021, an auditor from the West Virginia Tax Department again audited the Petitioner at its place of business. That audit resulted in the assessment that forms the basis of this matter. Tr. P76 at 1-18.

6. Sometime between the filing of its appeal with this Tribunal, and the evidentiary hearing, the parties settled a large portion of the assessment. As a result, at the time of the hearing,

the Petitioner's sole complaints concerned three (3) issues. First, the Petitioner argued that $x,xxx.xx of the assessment was improper because it involved repairs to equipment owned by the Petitioner that was directly used in the production of natural resources. Second, the Petitioner argued that $x,xxx.xx involved repairs to equipment that was directly used in providing a public service. Finally, the Petitioner argued that penalties were not warranted, due to the Petitioner's belief that it was following the guidance it was given at the conclusion of its 2014 audit.

DISCUSSION

There are two (2) statutory provisions at play in this matter. The first is colloquially the "direct use" exemption, and it is contained in Section 9 of Article 15, Chapter 11

> The following sales of tangible personal property and services are exempt from tax as provided in this subsection: . . . (2) Sales of services, machinery, supplies and materials directly used or consumed in the activities of manufacturing, transportation, transmission, communication, production of natural resources, gas storage, generation or production or selling electric power, provision of a public utility service or the operation of a utility service or the operation of a utility business, in the businesses or organizations named in this subdivision and does not apply to purchases of gasoline or special fuel;

W. Va. Code Ann. § 11-15-9(b)(2) (West).

Two (2) categories of the Petitioner's purchases are in dispute in this matter. First, and most contentious, is the materials the Petitioner purchases to make repairs to its equipment while it is doing work for PSDs and municipalities. In plain English, when the Petitioner is digging a trench for an entity engaged in the activity of providing a public utility service, and a hose on the backhoe breaks, the Petitioner believes the purchase of the replacement hose should be exempt from sales or use tax. Or, put another way, the Petitioner argues that the replacement hose is being directly used in an exempt activity.

Before we can rule on this issue, we must address the unavailing arguments made by both parties in post-hearing briefs. When the Petitioner was audited in 2014 it was instructed to do some type of apportionment for purchases such as our hose example discussed above. While the methodology of the apportionment was not made crystal clear, the unrebutted testimony from the Petitioner's witnesses was that they were told that going forward they could obtain a partial exemption from sale and use tax, based upon some apportionment formula regarding how much time our proverbial hose was used on an exempt job versus a taxable job. There was no testimony about the details of this apportionment formula, nor what statutory or regulatory authority allowed for such apportionment. In post-hearing briefs, both parties fixate on this mysterious formula. In its initial post-hearing brief, the Petitioner devotes two (2) sentences to this issue.

> The testimony was that the Petitioner was providing a service to a PSD and that the service was bided [sic] services and that the equipment used was identified in the bid. The purchases were purchased at the time the equipment was on the tax-exempt worksite and if not completely consumed on the site were allocated by the agreement reached with the Respondent in the settlement of the 2014 audit.

See Petitioner's Brief In Support of Petition for Reassessment P9.[1]

For his part, the Tax Commissioner's post-hearing brief is also less than illuminating. The Tax Commissioner cites Title 110, Series 15J of the West Virginia Code of State Rules, which is an interpretive rule regarding a per se exemption from sales and use tax for purchases by contractors doing work for PSDs and municipalities. Unfortunately, counsel for the Tax Commissioner neglected to discuss the applicability of this rule at either of the two (2) pre-hearing conferences held in this matter.[2] This Tribunal regularly admonishes litigants not to cite legal authority in their post-hearing briefs that have not been discussed at the pre-hearing conference,

[1] The Petitioner's Reply Brief contains the same argument, with almost identical verbiage.
[2] The Tax Commissioner mentions W. Va. Code R. § 110-15J-1 *et seq* in his second prehearing statement, but only to state that the Petitioner's reliance on it was misplaced.

but our admonishments are regularly ignored. Even if we were willing to entertain the argument regarding Series 15J, neither party discusses how, as an interpretive rule, it comports with the statutory and regulatory provisions concerning the direct use exemption.

The seminal case on the interplay between statutory and regulatory provisions in West Virginia is Appalachian Power Co. v. State Tax Dep't of W. Virginia, which states:

> Legislative rules have the force of law. Interpretive rules, on the other hand, do not create rights but merely clarify an existing statute or regulation. Because they only clarify existing law, interpretive rules need not go through the legislative authorization process. Although they are entitled to some deference from the courts interpretive rules do not have the force of law nor are they irrevocably binding on the agency or the court. They are entitled on judicial review only to the weight that their inherent persuasiveness commands.

Appalachian Power Co. v. State Tax Dep't of W. Virginia, 195 W. Va. 573, 583, 466 S.E.2d 424, 434 (1995)(internal citations omitted). As stated above, neither party argues whether Section 15J accurately clarifies West Virginia Code Section 11-15-9(b)(2) (the direct use exemption), or Section 15J's inherent persuasiveness.

It is clear from the totality of the testimony and post-hearing briefs that both parties agree on two (2) facts. First, that the Petitioner is selling a service to the PSDs and municipalities, as opposed to tangible personal property, and second, that this sale of a service is exempt from sales and use tax. The legal question to be answered is, when the Petitioner buys our proverbial hose, is it allowed to step into the shoes of its tax exempt customer? Neither party has pointed this Tribunal to any controlling statutory or regulatory authority that answers that question. We are well aware that the Petitioner argues that the answer is simple, the hose represents the sale of a supply, directly used in the activity of the provision of a public utility service, as those terms are used in West Virginia Code Section 11-15-9(b)(2). At first blush, this argument passes the straight face test, but our inquiry must go deeper. We are unable to rule for the Petitioner on this issue

because it never explains the statutory or regulatory authority for a **double exemption**. The Petitioner does not charge sales tax on the sale of the overall service to its tax exempt customers. It is not clear that in this scenario there can be two (2) exempt sales, the original sale of the service, and the subsequent sale of tangible personal property to the Petitioner, as opposed to a sale directly to the tax exempt entity. Simply put, is the Petitioner in this case standing in the shoes of the tax exempt entity when it buys the hose? The answer may well be yes, however, the Petitioner has offered no authority for that proposition. Although, the answer also may well be no, due to the fact that the hose stays with the Petitioner once the job is complete.

The next argument advanced by the Petitioner is simpler, because, when it comes to repairs to the vehicles at its limestone quarry, the Petitioner is the one performing the tax exempt activity, namely, the production of natural resources. And again, the Petitioner argues that the repairs and maintenance to its trucks that take the limestone from the crusher to its stockpile involve the sale of supplies and materials directly used in the exempt activity. The Tax Commissioner does not directly dispute that the Petitioner is engaged in the activity of the production of natural resources, or that the repair and maintenance purchases are directly used in the activity. Instead, the Tax Commissioner, unfortunately, again relies on a legal argument that was not discussed at either of the two (2) prehearings held. The Tax Commissioner relies on Section 123.4.3.3 of the Sales and Use Tax Regulations, contained in Title 110, Series 15 of the West Virginia Code of State Rules, which states:

> 123.4.3.3. Activities Not Included in the Production of Natural Resources. - The production of natural resources shall not include the following:
>
> 123.4.3.3.a. In the case of limestone quarried or mined, any activity after the stone is severed and reduced to possession on the surface. **Processing of limestone is considered to be manufacturing**.

W. Va. Code R. § 110-15-123.4.3.3.a (1993)(emphasis added).

Putting aside the fact that the Tax Commissioner is again relying on a legal authority that was not discussed at the prehearing conference, we find the Respondent's reliance on Subsection 4.3.3 to be quite baffling. Again, this argument between the parties involves repair and maintenance costs for the trucks that transport the limestone from the crusher to the stockpile. Even if we are willing to address the Tax Commissioner's argument in this regard, it is unconvincing, precisely because of the emphasized language above. The Tax Commissioner is arguing that once the limestone is severed from the earth, the Petitioner is no longer engaged in the activity of the production of natural resources. However, the Tax Commissioner ignores the highlighted language above, which clearly and unequivocally states that processing of limestone is manufacturing. Manufacturing is also one of the activities that is subject to the direct use exemption. Therefore, it is difficult to reconcile how the Tax Commissioner believes that a regulatory provision that clearly and unambiguously states that the activity of processing the blasted limestone is also subject to the direct use exemption helps his cause. It should be noted that the Petitioner, in its Reply Brief loudly points out the weakness of the Tax Commissioner's argument in this regard.

There are numerous other problems with this argument between the parties, and we will attempt to peel the onion. First, at hearing the Tax Commissioner's witness did not mention, nor seem to even know of the existence of Subsection 4.3.3 of Title 110, Series 15. This leaves unanswered the obvious question, if one is to even entertain the Tax Commissioner's argument. Assuming that the Petitioner is involved in the activity of the production of natural resources when it removes the limestone and then is involved in the activity of manufacturing when it transports the material to the crusher and prepares it for sale, what activity is the Petitioner involved in after the material leaves the crusher? Given the plain language of Subsection 4.3.3, that is the only argument that could be made, namely that once the rock leaves the crusher, and is transported to

the stockpile in anticipation of sale, the Petitioner is engaged in some other, non-exempt activity. However, the Tax Commissioner never advances such an argument. We are of the opinion that suggesting that the Petitioner's quarrying of limestone and preparing it for sale involves three (3) statutorily distinct activities, two (2) of which would be subject to the direct use exemption, and a third which would not be, leads to an absurd result, something the West Virginia Supreme Court of Appeals has cautioned against. *See e.g.,* Dunlap v. Friedman's, Inc., 213 W.Va. 394, 582 S.E.2d 841 (W.Va. 2003).

The second problem with the Tax Commissioner's reliance on Subsection 4.3.3 is that it presumes that West Virginia Code Section 11-15-2(b)(14)(A), the definition of the production of natural resources, is ambiguous, therefore necessitating clarification by Subsection 4.3.3. It is well settled under West Virginia law that, absent an ambiguous statutory provision, reliance on legislative rules is unwarranted. *See e.g.* Appalachian Power Co. v. State Tax Dep't of W. Virginia, *supra*. (agency regulations must reflect legislative intent, when statute is clear, an agency's interpretation must not conflict with the plain language of the statute.). It would have been up to the Petitioner to argue that the limitation of the definition of natural resources in Subsection 4.3.3 was necessitated by some ambiguity in West Virginia Code Section 11-15-2(b)(14)(A), but it has not done so.

Finally, even if we were to find that West Virginia Code Section 11-15-2(b)(14)(A) contained some ambiguity, it has been well settled, since the Appalachian Power decision that "if the Legislature explicitly leaves a gap in legislation, then an agency has the authority to fill the gap." Appalachian Power Co. 466 S.E.2d at 440, *see also* Griffith v. Frontier W. Virginia, Inc., 228 W. Va. 277, 719 S.E.2d 747, (2011). In his post hearing brief, the Tax Commissioner does not argue that Section 11-15-2(b)(14)(A) contains gaps necessitating clarification by Section 4.3.3.

Nor does the Petitioner's Reply Brief contain any argument that Section 4.3.3 is in conflict with Section 11-15-2(b)(14)(A).

The Petitioner's final argument concerns the Tax Commissioner's inclusion of additions to tax, pursuant to West Virginia Code Section 11-10-18. While both parties mention that Section 18 concerns additions to tax, neither party discusses which of the seven (7) subsections in Section 18 controls. Nor does either party offer any in depth analysis of what is necessary to assess statutory additions in West Virginia. Instead, both parties focus exclusively on the facts, namely that the Petitioner, at the conclusion of the 2014 audit, was instructed to apportion its purchases of materials and supplies, based upon a formula related to its work for exempt PSDs and municipalities. As one might expect, the Petitioner argues "we were just doing what we were instructed to do" and the Tax Commissioner argues that the Petitioner has not provided written proof that it was so instructed.

This Tribunal assumes that Subsection (c) of West Virginia Code Section 11-10-18 is the statutory provision that controls in this matter. It states, "If any part of any underpayment of any tax administered under this article is due to negligence or intentional disregard of rules (but without intent to defraud), there shall be added to the amount of tax due five percent of the amount of such tax . . . ." W. Va. Code Ann. § 11-10-18(c) (West). At hearing, both of the Petitioner's witnesses testified that they were instructed how, going forward, they were to apportion their supplies and material purchases for certain jobs. The Tax Commissioner was offered the opportunity to rebut this testimony, however he chose not to avail himself of the opportunity. We are unpersuaded by the Tax Commissioner's argument that the Petitioner presented no written evidence of the instructions it received.

In summation, of the three (3) issues of contention between the parties, the Petitioner prevails on two and the Tax Commissioner prevails on one. The Petitioner has failed to offer any

statutory, regulatory or case law authority that stands for the proposition that when it purchases supplies, **that it will keep**, it is standing in the shoes of the exempt entity it is supplying tax exempt services to. The Tax Commissioner has failed to offer any statutory, regulatory or case law authority that stands for the proposition that when the Petitioner is repairing the trucks that transport finished limestone from the crusher to the stockpile, the Petitioner is not engaged in either the activity of the production of natural resources, or manufacturing. Finally, the Tax Commissioner has failed to prove that the Petitioner was negligent, or intentionally disregarded any tax statutes or rules, when it apportioned the purchases discussed above. Therefore, we rule that the portion of additions to tax attributable to the two (2) amounts remaining in dispute, namely $x,xxx.xx and $ x,xxx.xx are vacated. Mathematically that amounts to a $x,xxx.xx reduction. The total amount of additions was $xx,xxx.xx, which is twenty-five percent (25%) of the total tax assessed. Twenty-five percent (25%) of $xx,xxx.xx ($x,xxx.xx + $ x,xxx.xx) is $ x,xxx.xx.

CONCLUSIONS OF LAW

1. It is the duty of the Tax Commissioner to see that the laws concerning the assessment and collection of all taxes and levies are faithfully enforced. *See* W. Va. Code Ann. §11-1-2 (West 2010).

2. "The Tax Commissioner shall collect the taxes, additions to tax, penalties and interest imposed by this article or any of the other articles of this chapter to which this article is applicable." W. Va. Code Ann. §11-10-11(a) (West 2010).

3. "An excise tax is hereby levied and imposed on the use in this state of tangible personal property, custom software or taxable services, to be collected and paid as provided in this article or article fifteen-b of this chapter, at the rate of six percent of the purchase price of the property or taxable services, except as otherwise provided in this article." W. Va. Code Ann. §11-15A-2(a) (West 2010).

4. The use in this state of the following tangible personal property, custom software and services is hereby specifically exempted from the tax imposed by this article to the extent specified: . . . (2) Tangible personal property, custom software or services, the gross receipts from the sale of which are exempt from the sales tax by the terms of article fifteen, chapter eleven of the code of West Virginia, one thousand nine hundred thirty-one, as amended, and the property or services are being used for the purpose for which it was exempted." W. Va. Code Ann. §11-15A-3(a)(2) (West 2013).

5. West Virginia Code Section 11-15-9(b)(2) provides an exemption from the consumers sales and service tax for sales of services, machinery, supplies and materials directly used or consumed in the activities of manufacturing, transportation, transmission, communication, or the production of natural resources.

6. In a hearing before the West Virginia Office of Tax Appeals, the burden of proof is upon the Petitioner to show that any denial of a tax refund is erroneous, unlawful, void or otherwise invalid. *See* W. Va. Code Ann. § 11-10A-10(e) (West 2019).

7. The Petitioner has not met its burden of showing that the $x,xxx.xx portion of the assessment against it, for repairs and maintenance to its equipment while performing contractual work for PSDs and municipalities was erroneous, unlawful, void or otherwise invalid.

8. The Petitioner has met its burden of showing that the $x,xxx.xx portion of the assessment against it, for repairs and maintenance to its equipment on its quarry site, was erroneous, unlawful, void or otherwise invalid.

9. "If any part of any underpayment of any tax administered under this article is due to negligence or intentional disregard of rules (but without intent to defraud), there shall be added to the amount of tax due five percent of the amount of such tax . . . ." W. Va. Code Ann. § 11-10-18(c) (West).

10. The Petitioner has met its burden of showing that it did not intentionally disregard any West Virginia statutes or rules, nor was it negligent by its underpayment of sales and use tax regarding repairs and maintenance to its equipment while performing contractual work for PSDs and municipalities.

DISPOSITION

Based upon the above, it is the **FINAL DECISION** of the West Virginia Office of Tax Appeals that the assessment issued against the Petitioner on August 25, 2021, in the amount of $xxx,xxx.xx is hereby **MODIFIED** to remove $x,xxx.xx of the tax due, and $x,xxx.xx of the penalties/additions assessed.

Interest continues to accrue on any unpaid tax until this liability is fully paid. W. Va. Code Ann. § 11-10-17(a) (2010).

WEST VIRGINIA OFFICE OF TAX APPEALS

By: _____
A.M. "Fenway" Pollack
Chief Administrative Law Judge

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Date Entered