STATE OF VERMONT
RUTLAND COUNTY, SS.

VERMONT MARBLE, INC., PLUESS-STAUFER INDUSTRIES, INC., OMYAVIATION, INC., and OMYA, INC., Appellants	}	**RUTLAND SUPERIOR COURT**
v.	}	
EDWARD W. HAASE, VERMONT COMMISSIONER OF TAXES, Appellee	}	**Docket No. S0013-98 RcCa**

OPINION and ORDER

This is an appeal from a Determination by the Commissioner of Taxes that taxpayers owe specified taxes and penalties. Edward v. Schwiebert, Esq., of Reiber, Kenlan, Schwiebert, Hall & Facey, P.C., represents the Appellant taxpayers. Danforth Cardozo, III, Esq., Special Assistant Attorney General, represents the Commissioner. The court has reviewed the record of the proceedings before the Commissioner, and the briefs filed by both attorneys.

The Appellants are several related companies in the business of mining and processing calcium carbonate ore into a finely ground powder that is sold in wet and dry bulk form and used in the manufacture of other products. Vermont Marble, Inc. was in existence for many years, until September 30, 1992. It operated marble quarries, manufactured marble products, and manufactured and sold electricity generated by hydropower from the Otter Creek. Pluess-Staufer Industries, Inc. (hereafter "PSI") acquired Vermont Marble, Inc., by stock purchase in 1977. In the late 1970's, PSI formed a new subsidiary company, OMYA, Inc. On September 30, 1992, Vermont Marble, Inc. and OMYA, Inc. merged, and the surviving company retained the federal and state identification numbers of Vermont Marble, Inc. and the name of OMYA, Inc. Omyaviation, Inc. is another subsidiary of PSI, and a sister company to OMYA, Inc. It provides air transportation for PSI, its subsidiaries, and other related companies. It does not provide any general public transportation of persons or property for hire. All companies were in existence as separate but related entities for at least a portion of the period covered by this appeal. All parties agreed to consolidate the cases of the separate taxpayers for purposes of the hearing before the Commissioner and this appeal.

The Department of Taxes has conducted audits of the Appellants in the past, generally for periods of three tax years at a time. The last audit prior to the one resulting in this case had been for the period ending June 30, 1990. In the past, the Department was not authorized by statute to assess penalties on audit assessments unless tax remained unpaid for 30 days after the notice of

assessment following an audit.

The period involved in this appeal is the three year period from July 1, 1990 to June 30, 1993, and the tax involved is the use tax. Appellants filed their tax returns on time, and paid $964,939 in sales and use taxes for the three year period. In July of 1993, the Department sent an auditor to undertake an audit of the period from July 1, 1990 to June 30, 1993. The audit lasted sixteen months. On November 29, 1994, the Department issued an assessment of additional tax due and penalties.

The Appellants appealed on December 16, 1994. As a result of the appeal, a revised field audit assessment was issued on April 13, 1995. On April 25, 1995, the Appellants appealed the revised assessment, and requested a formal hearing. The hearing before the Commissioner, acting through a hearing officer, took place on May 23, 1996, and the Commissioner's Determination was issued on December 11, 1997. This appeal was filed on January 18, 1998. All taxes, interest, and penalties assessed against the Appellants have been paid by them. The Appellants seek reversal of the Commissioner's Determination relating to a portion of the use tax and penalties.

There were three categories at issue before the Commissioner. The first was the auditor's assessment of $52,583 in use tax on rail car linings. On appeal, the Commissioner agreed with the Appellants' position, and reversed the assessment on this issue. The Department does not contest the Commissioner's Determination on rail car linings, and the tax paid, along with interest and penalties, has been refunded. Thus, the Commissioner's reversal of the assessment resolves this issue, and it is not before the court.

The second was $115,504 in use tax on internally generated electricity used in manufacturing, consisting of $60,605 from the assessment and denial of a refund of $54,899. The Commissioner determined that the taxpayers are liable for the tax, and Appellants are pursuing this issue on appeal.

The third was the auditor's imposition of $95,000 in penalties, consisting of a 25% penalty on all assessments arising from the audit, except for the tax on internally generated electricity used in manufacturing. The penalties were assessed on the use tax assessment for rail car linings ($52,583) as well as on additional assessments totaling $292,530 which the Appellants did not dispute and paid after the audit. The penalties assessed and paid on the rail car linings have been refunded. The remaining issue is the imposition of penalties after June 19, 1991 on additional tax assessed as a result of the audit.

Thus, the two remaining issues before the court for decision are the imposition of use tax on internally generated electricity used in manufacturing, and the imposition of penalties.

Standard of Review

This is an appeal from a decision of the Commissioner of the Department of Taxes pursuant to 32 V.S.A. § 9817, governed by V.R.C.P. 74 ("Appeals from Decisions of Governmental Agencies"). As such, this appeal does not call for a de novo hearing and decision by the court. Rather, the court reviews the record of the proceedings below. The findings of the Commissioner will not be set aside unless they are clearly erroneous. See *Morton Bldgs., Inc. v. Vermont Dep't of Taxes*, 167 Vt. 371, 374 (1997). The court grants deference to the expertise and informed judgment of the Commissioner with respect to the subject matter of the Department. See *In re Twenty-Four Elec. Utils.*, 160 Vt. 227, 233 (1993). The court applies a deferential standard in interpreting regulations of an administrative agency that have been adopted pursuant to statutory authority. See *Conservation Law Found. v. Burke*, 162 Vt. 115, 121 (1994). The court grants deference to the Department with respect to selection of suitable auditing techniques for determination of taxable events. See *In re DeCato Bros.*, 149 Vt. 493, 495-96 (1988) (citing *Clark Oil & Refining Corp. v. Johnson*, 506 N.E.2d 1362, 1365 (1987) ("implicit in the powers granted to [the agency] in the [Use Tax] Act and elsewhere in the statutes is the authority to establish the method by which use taxes are to be calculated.")). An administrative agency's interpretation of a statute it is responsible for executing will be upheld, "absent compelling indication of error" in the interpretation. *Burlington Elec. Dep't v. Vermont Dep't of Taxes*, 154 Vt. 332, 337 (1990) (cited in *Tarrant v. Vermont Tax Dep't*, 10 Vt. L.W. 88, 90 (1999)).

Internally Generated Electricity used in Manufacturing

The period of taxation in relation to this issue is the ten months from the time of the merger of Vermont Marble, Inc. and OMYA, Inc., on September 30, 1992 to the last date of the audit period, or June 30, 1993. In other words, it is the post-merger OMYA, Inc. against which the disputed use tax has been assessed. The Commissioner upheld the assessment of a use tax against OMYA, Inc. for the use of electricity it generated and used in manufacturing its products for each of the ten months after the merger.

Electricity is treated as tangible personal property subject to the sales and use tax pursuant to 32 V.S.A. §§ 9701(7), 9771(1), 9773(1). During the relevant period, manufacturers were subject to use tax on their own use of tangible personal property manufactured by them if they also offered the same kind of tangible personal property for sale.[1] See 32 V.S.A. § 9773(2). In other words, if they produced power and sold some and also used some in manufacturing other products, they paid sales tax on the portion they sold, and use tax on the portion they used to manufacture other products. Under the statute, there was a specific exclusion from the definition of "sale" with respect to electricity: a "sale" for purposes of the statute did not include

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[1]Beginning in 1996, a statutory amendment provided that electricity used in manufacturing was not subject to the sales and use tax regardless of whether the electricity was generated by the manufacturer or purchased from another entity. See 32 V.S.A. § 9741(14), (34).

electricity internally generated by the manufacturer for its own use if at least 60% of the power "generated annually by the taxpayer" is used by the taxpayer in its trade or business. *Id.*

The title and relevant statutory provisions are:

> **§ 9773. Imposition of compensating use tax**
> Unless property has already been or will be subject to the sales tax under this chapter, there is imposed on every person a use tax at the rate of five percent for the use within this state, except as otherwise exempted under this chapter:
> . . .
> (2) Of any tangible personal property manufactured, processed or assembled by the user, if items of the same kind of tangible personal property are offered for sale by him in the regular course of business, . . .; and for purposes of this section only, the sale of electrical power generated by the taxpayer shall not be considered a sale by him. . .in the regular course of business if at least 60 percent of the electrical power generated annually by the taxpayer is used by the taxpayer in his. . .trade or business. . . .

32 V.S.A. § 9773(2).

Prior to the merger of Vermont Marble, Inc. and OMYA, Inc., Vermont Marble, Inc. produced power that was sold to OMYA, Inc. for its use in manufacturing. Vermont Marble, Inc.'s sales to OMYA were subject to Vermont sales tax. Together, prior to the merger, Vermont Marble and OMYA used more than 60% of the power generated by Vermont Marble in manufacturing their products. After the merger, it was OMYA's Vermont Marble Power Division that produced the electricity used in OMYA's manufacturing processes. The substantive manufacturing and power production operations did not change as a result of the merger, although the corporation itself had changed. From October 1, 1992 to September 30, 1993, OMYA used more than 60% of its power production in its own manufacturing.[2] The

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[2]The Commissioner made the following findings on the facts stated above: "The taxpayers' manufacturing profile has remained basically unchanged during the ten years preceding the conclusion of the audits under appeal." (Determination, Findings of Facts, para. 25.) "The taxpayers' basic manufacturing product has not changed over time prior to the audits." (*Id.* para. 26.) "The combination of Vermont Marble, Inc. and Omya, Inc. was effected by an exchange of book value assets and liabilities for a paid-in-capital adjustment. Internally, the companies continued to operate separately after the combination." (*Id.* para. 44.) "The merger on September 30, 1992, of Vermont Marble Co. and Omya changed what had previously been a straight-forward taxable sale of tangible personal property (electricity) to self-use of tangible personal property. . . ." (*Id.* at 26.) "Here, one of the anticipated tax benefits [of the merger] involved an exemption from use tax on the use of self-generated power. Testimony indicates that such a result will occur, absent any other major changes in operations." (*Id.* at 29.) The Commissioner, in briefs, did not dispute Appellants' argument that during the one period

auditor determined that a use tax was payable for each of the ten months of the audit period after the merger date, using an interpretation of the 60% test that Appellants contend is clearly erroneous under the statute, but was upheld by the Commissioner in his Determination. Appellants' position is that because, beginning with the date of the merger, OMYA used at least 60% of its internally generated power for its own manufacturing purposes on an annual basis, it owes no use tax for the period of October 1, 1992 to June 30, 1993.

As a preliminary matter, Appellants correctly point out that the method of measurement that the Commissioner "upheld" was slightly different than the one that the auditor actually applied. Administrative agency findings will not be set aside unless they are clearly erroneous. See *Morton Bldgs., Inc. v. Vermont Dep't of Taxes*, 167 Vt. 371, 374 (1997). The Commissioner's finding as to the method of measurement was clearly erroneous because it did not accurately describe the method used in the audit. Nonetheless, as will become apparent from the analysis, the factual discrepancy is immaterial in view of the court's conclusion that the Commissioner's interpretation of the controlling statute is erroneous.

The auditor's method of determining whether electricity generated internally by OMYA Inc. and used in its manufacturing process was subject to use tax after the merger was to look at the use of self-generated power during a twelve month period ending with the month prior to the month being reported,[3] using a rolling calculation method that was repeated each month. As that approach was applied in this case, the auditor took into account the ratio of use from Vermont Marble prior to October 1992 and OMYA, Inc. after October 1992. Although the combined companies after the merger had operations that qualified, Vermont Marble prior to the merger did not meet the 60% test. Based upon measurements from Vermont Marble, and using the rolling calculation method, the auditor determined that the 60% self-use minimum was not met for each of the months from October 1992 through the end of the audit period, or June 30, 1993.

The Commissioner approved of the auditor's approach, and made a Finding of Fact that "the required 60% self-use minimum was not met." (Determination, para. 42). The Commissioner used as the starting point for construction of the statute the requirement that a taxpayer has a statutory obligation to accrue and remit sales and use taxes on a monthly basis. See 32 V.S.A. § 9775. The Commissioner reasoned that the auditor's method accommodates the taxpayer's obligation to remit taxes on monthly purchases. The Commissioner further invoked the authority of the Department to determine the method for calculation of taxes, citing *In re DeCato Bros., Inc.*, 149 Vt. 493 (1988). In *DeCato Bros.*, however, the court upheld the Department's use of an auditing technique to extrapolate from existing records of a sample month the number of truck trips the taxpayer made during a period in which the taxpayer had lost

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following the date of the merger, OMYA, Inc. used more than 60% of the electricity it generated in the manufacture of its own products.

[3]The Commissioner incorrectly described this as the twelve month period ending with the month for which liability was being reported. (Determination at 10, para. 41).

its records, where truck trips were taxable. See *DeCato Bros.*, 149 Vt. at 496. The Court did not defer to the auditor the issue of construing a statute that uses an annual business cycle in its definition of what is or is not taxable.

In his briefs before this court, the Commissioner argues that the sales and use tax is a transactional tax, with liability accruing on a monthly basis as transactions occur. He argues that the Department's method is a reasonable one for calculation of a tax payable monthly, and further argues that it is the *only* method consistent with a monthly remittance obligation. He contends that it is an administratively reasonable construction of the word "annually" in the statute, and that it is in line with legislative intent because of the monthly obligation to remit. He further argues that the 60% self-use category is an exemption from tax, and should therefore be strictly construed against taxpayers. His position is that it is the obligation of a newly formed company to show its entitlement to the exemption, and that until sufficient use is shown to establish the 60% self-use level, the use tax is due and payable. He argues that the rolling monthly calculation method is a valid method for measuring entitlement to the exemption.

Appellants rely on an interpretation of the statute that focuses on the 60% self-use provision as defining an exclusion from taxation for a category of electricity, i.e., self-generated electricity used by the company in manufacturing, rather than as creating an exemption applicable to particular transactions measured on a monthly basis. They argue that exclusions should be broadly interpreted in favor of the taxpayer. They further argue that the Department is wrong to use a method that looks backward in time to the operations of Vermont Marble during the months prior to the merger to determine eligibility for the exclusion after the merger. They argue that from the first day after the merger, OMYA was producing and using power in a manner that qualified it for the exclusion.

Both sides proceed from the premise that the statute should be interpreted to further legislative intent. Legislative intent is derived from an interpretation of the language of the statute, including structure and context as well as individual words. "An important canon of statutory construction is that the intent of a statute should be gathered from a consideration of every part of the statute, the subject matter, its effects and consequences, and the reason and spirit of the law." *In re R.S. Audley, Inc.*, 151 Vt. 513, 519 (1989).

It is readily apparent that the Legislature created a tax structure in which companies that primarily sold electricity were required to collect a tax on sales of electricity, and companies that bought electricity to use in manufacturing were required to pay either a sales tax at purchase or a compensating use tax on the electricity purchased at the time of use, but a company that used most of the electricity it produced for its own manufacturing purposes was entitled to pay no tax on the electricity it used.[4] This interpretation reflects a tax break for manufacturers who produce electricity primarily for their own use, and is in accord with the language, structure and purpose

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[4]As previously noted, current law provides for no sales or use tax at all for electricity used in manufacturing. See 32 V.S.A. § 9741(34).

of the statute.

The statute focuses on whether or not the power produced by the manufacturer "is used by the taxpayer in his . . . trade or business. . ." The language "is used" refers to current use, which in this case is use after the merger for tax reporting months after the merger. The issue is what was the level of use during each month after September 30, 1992, not before. It is the company that was in business after the merger that is being defined by the statutory provision at issue, and not the old Vermont Marble, Inc. The focus should be on its eligibility for the tax preference in relation to its operations beginning with October 1, 1992. Therefore, the question is whether, after October 1, 1992, it was functioning in a manner such that its expected annual use would exceed 60% of the electricity it produced. The standard for determining eligibility is the ratio of use of power "generated annually by the taxpayer" during the time of the taxpayer's own existence. This language calls for a determination of whether the level of use by the company during the monthly tax reporting period is such that, if a full year of operations is considered, the use would be over 60%. The language of the statute does not focus on the company's history prior to the reporting month. Rather, it calls for an annualized analysis of the company's use according to how it functions during the tax reporting months, which for the period of this appeal was the months after the merger.

The statute is a difficult one to interpret because of its complex sentence structure. In addition, 32 V.S.A. § 9773 has to be read in relation to 32 V.S.A. § 9741(14). When the language is read carefully, however, the analysis proceeds as follows:

1) If a taxpayer meets the 60% test (however that is measured), its sales of electricity to others are not defined as "sales" under the first part of the statute. In other words, if a manufacturer uses 75% of the power it produces in its own manufacturing processes, and sells the remaining 25% to others as a regular business practice, the sale of the 25% to others is not counted as a "sale" under this language: "[I]f items of the same kind of tangible personal property are offered for *sale* by him or her in the regular course of business . . . ." 32 V.S.A. § 9773(2). (Emphasis added.)

2) Thus, if a taxpayer meets the 60% test, the entire "[I]f . . . ." clause (quoted above) does not apply at all.

3) If the whole "[I]f . . . ." clause does not apply, then 32 V.S.A. § 9773(2) is entirely inapplicable to the manufacturer. There is no special imposition of a compensating use tax for the use of electricity generated internally by a manufacturer for its own use in manufacturing.

4) In that situation, the applicable statute is 32 V.S.A. § 9741(14), which excludes from sales and use tax tangible personal property (including electricity) that is consumed in the manufacturing process.

The structure and context of the statutes are important. 32 V.S.A. § 9741(14) lays out in a series of subsections a long list of activities that are not subject to the sales and use tax at all. These include major categories of transactions, such as those over which the state has no taxing authority, categories covered by other taxation statutes, categories of transactions that are

excluded for policy reasons, and other large groups. The subsections define in broad scope the parameters of applicability of the sales and use tax. Thus, although the word "exempt" is used in the introductory language, the effect is to define the categories of activities and taxpayers to which the sales and use tax does not apply. As such, it is in the nature of a statutory provision excluding from use taxation altogether certain categories, as opposed to carving out an exemption from tax for certain transactions which are otherwise clearly taxable. Viewed in context, the provision at issue serves to define a category of transactions not subject to taxation, rather than an exemption.

Even more important is the structure and language of §9773(2). The sentence structure does not provide that manufacturers who produce their own power are exempt during certain months when their prior history of self-use in manufacturing exceeded 60%, and not exempt during other months when it did not. Rather, it singles out for purposeful treatment with respect to compensating use taxation those manufacturers who produce their own power -- if they meet the defined standard of self-use in manufacturing, all of their self-use transactions are nontaxable; if they do not meet the standard, all of their self-use transactions are taxable. The reference to annual power generation defines what the standard is, but if the standard is met, there is no tax on the self-use transactions. This is a specific statute addressing manufacturers who produce their own electricity, and creates an exception to the general exemption under 32 V.S.A. § 9741(14) (exempting tangible personal property consumed in manufacturing).

This analysis of the language and structure reveals the policy underlying the provision, which is to draw a line between those power producers who are required to pay compensating use tax on their use of power and those who are not. The distinction is whether or not most of the electricity they produce is used for their own manufacturing purposes, in which case they receive a tax benefit; if only a portion is used by themselves, they are treated like manufacturers who purchase electricity at retail, and must pay a compensating use tax. See 32 V.S.A. § 9773(1).

If a company qualifies for preferential treatment because it uses most of the power it produces in its own manufacturing, then according to the terms of the statute it should receive that tax benefit from the beginning of its operations. In this case that date is October 1, 1992. The legislative intent reasonably gathered from the use of an annual time frame is the recognition that power generation and manufacturing may not remain steady throughout the year, but may undergo seasonal changes and cycles. The recognized fact of seasonal variations throughout the year should not penalize a company for a year following a corporate merger when it is structured to qualify for, and deserves, the tax preference based on policy considerations. It should not have to wait twelve months to prove itself.

An interpretation of the statute that builds in a twelve month delay in the calculation of eligibility can easily result in abuses and practices inconsistent with the underlying policy. For example, a company that has qualified in the past but changes its operations to reduce its manufacturing and yet maintain its prior level of power production, selling most of its power instead of using it in manufacturing, would still qualify under the Department's approach, but it

should no longer qualify on policy grounds. It would be receiving an undeserved benefit based on historical facts that no longer existed during the later tax reporting months. This case involves the reverse situation. The Department's approach allows the Department to continue to collect additional months of use tax, as if the merger had not occurred, postponing for several months the date on which OMYA, Inc. becomes able to take advantage of the tax break for which its operations make it eligible. The outcome is equally indefensible from a policy point of view.

The Department is correct that a taxpayer needs to report and remit use tax on a monthly basis. The fact of monthly reporting, however, should not result in the use of an inapplicable time period, i.e., the past, at which time a different corporation operated a different business than the month in which the tax reporting takes place.

As pointed out in the briefs, the use tax is a so-called "trust" tax, in which the taxpayer reports its own liability based on its own records, and enforcement occurs through periodic audit. A company that produces power and uses some of it in its own manufacturing has an obligation to report and remit in a responsible manner, just as with other trust taxes. If, as of October 1, 1992, OMYA's business plan and reasonable projections supported the conclusion that it would show over time that it would qualify, it did not have an obligation to report and pay tax; if the business plan and reasonable projections did not support eligibility, then it had the obligation to report and pay the tax. For any month in which it reports and remits tax, it must make an educated projection, based on its current and ongoing business operations. If it turns out to be wrong, it will be subject to interest and penalties as well as the tax. This particular case did not involve a close call. It was predictable with a reasonably high degree of confidence that as a result of the merger, OMYA qualified as a company that would be using more than 60% of its self-generated power in its own manufacturing processes, and that turned out to be the case. From the moment of the merger, its planned operations showed that it would meet the standard, and it did. It was therefore entitled to the exclusion from use tax for its internally generated electricity used in its own manufacturing for each of the months following the merger. The fact that the merger reduced the level of tax revenue to the Department should not operate to deprive the taxpayer for twelve months of a benefit for which it qualified and to which it was entitled on policy grounds.

With respect to the Commissioner's argument that exemptions should be strictly construed against taxpayers, the Court's analysis in *McClure Newspapers, Inc. v. Dep't of Taxes*, 132 Vt. 169 (1974) is on point. The issue in that case was whether the photographing of news events should be considered part of the manufacturing process engaged in by a newspaper publisher, or whether it was merely the procuring of raw materials prior to commencement of the manufacturing process. See *id.* at 172-173. If the manufacturing process started when the news was gathered, flashbulbs, film and photographic tapes used to produce photographs for use in *The Burlington Free Press* were consumed in the manufacturing process and not subject to use tax. If manufacturing started when the presses began to roll, these items were not used in the manufacturing process, and were subject to use tax. The Court analyzed "the practicalities of

newspaper publishing," (*Id.* at 173), and concluded that newspapers do not manufacture news events, but take the raw materials of events or occurrences and process them into a publication. It concluded that in view of the statute and its purposes, the taking and preparation of photographs is encompassed within that manufacturing process, and the items were exempt from the use tax.

It specifically addressed the Department's argument, based on *Stowe Preparatory School, Inc. v. Town of Stowe*, 124 Vt. 392 (1964), that "[s]tatutes of exemption are to be strictly construed, and no claim of exemption can be sustained unless within the express letter or necessary scope of the exempting clause." *Id.* at 396. The Court stated:

> We have no difficulty in finding that McClure's claim of exemption is sustainable under the strict construction test of *Stowe*. Furthermore, we are not at all certain that this strict construction test is applicable here. The overall purpose of 32 V.S.A. § 9741 may be primarily definitional. A similar Massachusetts statute excluding enumerated items from the imposition of sales and use taxes was so characterized in *Wakefield Ready-Mixed Concrete Co. v. State Tax Commission,* 356 Mass. 8, 247 N.E. 2d 869, 871-72 (1969):
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> > We do not regard this type of statutory provision as the type of exemption concerning which a special burden rests upon the taxpayer, claiming the benefit of the provision, to bring himself within its scope. [Citations omitted.] The subsections are merely part of the statutory definition of the types of sales and uses of tangible personal property which are to be employed in measuring the excises and of those which are not so to be used.

McClure, 132 Vt. at 174-75.

The same framework applies in this case. It is not a question of OMYA, Inc. having to show entitlement to an exemption narrowly construed against it. Rather, the issue is whether the electricity on which the Department seeks to assess a use tax does or does not fall within the definitional limits of taxable or nontaxable electricity as established by the Legislature for tax years 1992-93. Furthermore, as in *McClure*, any statutory presumption in favor of the Department applies to sales taxes based on sales transactions, and not to use taxes applicable to manufacturing. See 32 V.S.A. § 9813; *McClure*, 132 Vt. at 175.

Further, administrative convenience is not a sufficient basis for justification of the Department's interpretation where the administrative agency's method conflicts with the reasonable interpretation of the language and underlying policy of the statute. It is not acceptable for the Department to develop a yardstick based on an inapplicable period and use it to disqualify the company from tax treatment for which it qualifies for the reason that the method is administratively convenient. While administrative convenience is a good reason to permit one method to be used over another when they both meet statutory requirements, and it might justify

deference to the agency interpretation if there are two plausible interpretations, both of which uphold legislative intent, as in *Audley*, 151 Vt. at 516, it is not a valid basis for using a method of measurement that does not comport with the language and purpose of the controlling statute.

For the foregoing reasons, the court concludes that the Commissioner's interpretation of the statute was erroneous. The rolling monthly calculation method as applied in this case (whether the one used by the auditor or the one inaccurately described by the Commissioner) conflicts with the language and purpose of the statute. The Commissioner's interpretation relies on the historical experience of a taxpayer that no longer exists to disqualify a newly organized taxpayer from a tax exclusion for which it qualified during the tax reporting months included in the audit.[5] The Determination is reversed on this issue, and Appellants are entitled to a refund of use tax and interest erroneously paid pursuant to the Determination.

Because this decision is based on statutory grounds, it is unnecessary to consider Appellants' claim of denial of equal protection.

Penalties

The Commissioner upheld the imposition of penalties on the taxes determined to be due as a result of the assessment, although with respect to three portions of the original assessment, penalties are not at issue on this appeal. The first is that the Department did not assess a penalty on the tax on self-generated electricity used in manufacturing, since the Department acknowledged that resolution of that issue required interpretation of the statute. The second is that when the Commissioner reversed the assessment of use tax on rail car linings and ordered a refund of tax and interest, penalties previously paid were also refunded, and are therefore not at issue at this time. The third is that this appeal only concerns penalties assessed on additional assessments of tax after June 19, 1991, when there was a change in the penalty provision of the law. The penalties remaining, which Appellants contend were imposed based on an erroneous application of the law, consist of the 25% penalty relating to the period after June 19, 1991 on the portion of the assessment that Appellants do not contest.

The penalty statute was amended in 1991, and the revision constituted a substantial change from the prior provisions. The previous provision made tax payable 30 days following assessment of a deficiency. Except for fraud penalties under a separate statute, penalties could not be assessed on an audit unless the tax was unpaid after the 30 day period. As a result of the change, penalties could be imposed on an audit assessment immediately.

The relevant portion of the statute that became effective on June 19, 1991 states:

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[5]The rolling calculation may provide pertinent information for a taxpayer whose operations and business structure have remained unchanged for more than a year. In that circumstance it is a valid factor to take into account. That is different than adopting it as the only measurement for the 60% test, and applying it to data from a corporation that no longer exists.

> (c) When a taxpayer, without fraud or willful intent to defeat or evade a tax liability imposed by this chapter, fails to pay that tax liability on the date prescribed therefor:
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> . . . .
>
> (2) if the taxpayer fails to pay the tax liability in full at the date prescribed therefore, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, in addition to any interest payable pursuant to subdivision (1) of this subsection, the commissioner may assess, and the taxpayer shall then pay a penalty which shall be equal to five percent of the outstanding tax liability for each month, or portion thereof, that the tax liability is not paid in full; provided, however, that in no event shall the amount of any penalty imposed hereunder exceed 25 percent of the tax liability unpaid on the prescribed date of payment.

32 V.S.A. § 9814(c)(2).

The facts are clear that the maximum penalty of 25% was imposed on all categories resulting from the audit assessment on an "across the board" basis (except for self-use of electricity in manufacturing).[6]

After the change in the penalty statute that took effect on June 19, 1991, the Department began to assess penalties on all audit assessments as a rule rather than as an exception. That had not been the past practice. The Commissioner so found. (See Determination, Findings of Facts, paras. 19, 31, 32, and 45.)

The Commissioner's Findings of Facts also state that with respect to OMYA, Inc., "[p]enalties were assessed by the auditor because the issues assessed were generally the same issues assessed in the prior audits." (Determination, Findings of Facts, para. 53.) The Commissioner does not describe what those issues are, or the extent of their sameness, but cites to the auditor's testimony and exhibits. The auditor's statement is: "Penalties were assessed because the issues assessed were generally the same as in the prior audits." ("Prefiled Test. of Kim Socia" at 8.) Nothing more is said to describe the issues. The auditor continued: "For the purposes of comparison, copies of databases which list items of taxable tangible person property for the '87-'90 audit and the '90-'93 audits are attached as exhibits 14 and 15." (*Id.*) Comparison of exhibits 14 and 15 does not help to define the issues involved in imposition of the use tax, as

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[6]The categories and the amount of assessment are:

Fuel used in manufacturing	$78,991
Computer software	10,408
Power purchased	99,724
Miscellaneous	103,407
Total	$292,530

Penalties were also imposed on the tax on rail car linings. Those penalties have been refunded along with taxes and interest pursuant to the Commissioner's reversal of the auditor on that issue.

there are no category headings for the '90-'93 audit.

With respect to PSI, the Commissioner finds as fact that "[p]enalties were assessed by the auditor because the issues were generally the same as in the prior audits, in particular the failure to report use tax on untaxed purchases." (Determination, Findings of Facts, para. 57.) The Commissioner does not describe what those issues are except for the reference to untaxed purchases, or the extent of their sameness to the prior audit, but cites to the auditor's testimony and exhibits. The auditor's statement is: "Penalties were assessed because the issues assessed were generally the same as in the prior audits." ("Prefiled Test. of Kim Socia" at 9.) Nothing more is said to describe the issues. The auditor continued, "For the purposes of comparison, copies of databases which list items of taxable tangible person property for the '87-'90 audit and the '90-'93 audits are attached as Exhibits 18 and 19." (*Id.*) Comparison of exhibits 18 and 19 does not help to define the issues involved in the imposition of use tax as there are no category headings. These findings and the record demonstrate the "across the board" manner in which penalties were imposed on all taxes assessed as a result of the audit.

The Commissioner did not accept Appellants' argument that determining when use tax is or is not payable at various stages of a manufacturing enterprise is complex and sometimes difficult to determine from statutory provisions, and that there should be no penalty the first time a new application of the tax is assessed arising out of an audit, particularly where the manufacturer has a history of reporting and paying use tax. The Commissioner dismissed this argument on the grounds that "these companies deal with the sales and use tax on a daily basis," and ignorance of the law is not an excuse. (Determination at 20). The Commissioner also did not find compelling Appellants' argument that they have a track record of complying with determinations of new applications of the use tax when taxability has been reviewed in an audit. The Commissioner defended the automatic imposition of penalties on an assessment on the grounds that it is not appropriate for a taxpayer to decline to pay taxes until forced to do so, and that Appellants' claim of complexity is an excuse for not paying unless enforcement exists through a Department audit.[7] (See *id.* at 18-19).

The Commissioner made no attempt to distinguish between clearly established applications of the use tax, such as for purchases of supplies that are clearly taxable, and applications involved in items used in a manufacturing process that may or may not be taxable, depending on statutory interpretation. The record shows that the auditor had not made such a distinction either, except with respect to self-use of internally generated electricity. Appellants argue that in manufacturing, the line can be difficult to draw. They cite examples, such as the fact that some purchases of computer software are subject to use tax and others are not, and spare parts for some loaders are taxable and others are not, depending on the particular stage in the manufacturing in which they are used. They argue that automatic penalty imposition penalizes

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[7]The Commissioner found as fact that the level of underreporting by OMYA was 20%, by PSI it was 42.43%, and by Omyaviation it was 5.59%. (See Determination, Findings of Facts, paras. 54, 58, and 61.)

legitimate mistakes.

The Commissioner approved the Department practice of automatically adding the penalty on the full amount of additional use taxes assessed arising from a field audit, and he relied on a construction of the penalty provision that he stated as follows:

> 32 V.S.A. § 9814 imposes a penalty whenever the tax is not paid when due. The commissioner may exercise his or her discretion not to impose a penalty when the taxpayer can show the tax was not paid or was underreported due to reasonable cause and not willful neglect. The commissioner's discretion to waive the penalty imposed under 32 V.S.A. § 9814 thus is limited to circumstances showing reasonable cause and lack of willful neglect. If such a showing is not made to the satisfaction of the commissioner, the penalties must be assessed. *Mansfield Television, Inc. v. Commissioner of Taxes*, 133 Vt. 284 (1975); *Piche v. Department of Taxes*, 152 Vt. 229 (1989). This is not ambiguous.

(Determination at 21.) The Commissioner articulated the same construction more succinctly on pages 16-17: "After [the amended statute's] effective date, deficiencies assessed through audit became immediately subject to the 5% per month penalty. Abatement of penalty occurs only when a taxpayer establishes on appeal to the Commissioner's satisfaction that the underpayment was due to reasonable cause and not willful neglect. The burden is on the taxpayer to make this showing." (*Id.* at 16-17.)

The Commissioner's construction of the statute is that when a tax is found to be payable as a result of an audit, a penalty is automatic. The burden then shifts to the taxpayer to bring forth reasons to persuade the Department why the case falls within one of the two penalty exceptions set forth in the statute. If the taxpayer does not bring forth a basis for waiving the penalty, it "must be assessed." (Determination at 21.) This is essentially a two-step process. In the first step, if a tax is assessed, a penalty is assessed. The second step only occurs if the taxpayer seeks removal of the penalty; the burden is on the taxpayer to show reasonable cause or lack of willful neglect, and these are the only bases for removing a penalty. The Commissioner believes he has no power to decline to assess a penalty without the taxpayer having met a burden to place itself within one or the other of these two exceptions. The Commissioner determined that in this case, the taxpayers had not met their burden of showing reasonable cause or lack of willful neglect.

The court agrees with the Appellants that this is an erroneous construction of the statute. If the Legislature had wanted to establish such an automatic penalty scheme, it could have done so. Instead of the two-step process that the Commissioner has read into the statute, the language sets forth a three-step process. First, the tax is imposed. Then, if the Department has information from any source, including from the taxpayer or its own auditor or exchanges of legal interpretations by Department and taxpayer attorneys or otherwise, that either one or the other of the two specified circumstances apply (reasonable cause or lack of willful neglect), then there is no basis for imposition of a penalty. The third step is that if neither of the two conditions are met,

then the Department *may* impose a penalty. This provision signifies that the Department is to exercise its judgment about whether a penalty is warranted under the circumstances or not.

The legislative intent most reasonably derived from the language is that the Department is expected to evaluate the circumstances and exercise judgment in deciding whether to impose a penalty or not, at least at the level of Commissioner review. It shows an understanding of the fact that there are a variety of circumstances in which a penalty is warranted, even if there is no evidence of deliberate intent qualifying for the heavier penalty under the fraud penalty statute, and other circumstances in which it is not warranted. The change in the language of the penalty statute permitted penalties to be assessed on an audit immediately, without waiting 30 days for the payment of the tax, but it did not go as far as establishing a legislative intent that *no* discretion should be exercised within the Department in the wide variety of circumstances that can occur. The primary change was to alter the timing of imposition of a penalty, but not to replace the exercise of judgment with an automatic penalty amounting to a tax surcharge.

A case relied on by the Commissioner in his decision, *Mt. Mansfield Television, Inc. v. Commissioner of Taxes*, 133 Vt. 284 (1975), does not actually support the Commissioner's position. In that case, the Court held that the Commissioner had not abused his discretion when he had refused to abate the penalty on one portion of the assessment. The Court pointed out that he *had* abated it on another portion of the assessment, showing that he had not treated penalties as automatic, but had engaged in an act of exercising discretionary authority. The Commissioner did not do so in this case, but rather concluded that he had no discretionary authority, and could only abate a penalty if the taxpayer met a burden within narrowly defined bounds.

The Vermont Supreme Court reviewed the Commissioner's exercise of discretion in another case relied on by the Commissioner. The case involved the income tax, but it was similar in that there was a Department policy automatically imposing a penalty for a late filing. The Court reversed the trial court's reversal of a penalty, and stated:

> The fact that the penalty was imposed automatically by the Department of Taxes when the delinquency was discovered does not negate the exercise of discretion on the part of the Commissioner, *particularly when any penalty assessed is subject to individual review upon appeal to the Commissioner*. 32 V.S.A. § 5883. It merely represents the full extent to which the Commissioner has chosen to exercise his discretionary authority as granted under the statute. Thus, the superior court committed error by concluding that the Commissioner abused his discretion and reversing the assessment of the penalty. See *Finkle v. Town of Rochester*, 140 Vt. 287, 289, 438 A.2d 390, 392 (1981) (decisions left to the discretion of an administrative agency "will not be disturbed unless there is shown an abuse of discretion").

Piche v. Department of Taxes, 152 Vt. 229, 234 (1989) (emphasis added.).

First, it is significant that the case involves income tax rather than the compensating use tax. The penalty provisions are different for the two categories. The statutes governing penalties for income tax are set forth in 32 V.S.A. §§ 5881-5885, whereas the statutes governing penalties for sales and use tax are set forth in 32 V.S.A. § 9814. The taxable events, nature of filing returns, and ability to accurately determine the amount of tax due are different between the income tax and the use tax in a manufacturing context. See *McClure*, 132 Vt. at 169, and *Morton*, 167 Vt. at 371, as well as the issues in this case of use tax on rail car linings and on internally generated electricity used in manufacturing for examples of how complicated it can be to determine whether the use tax should be imposed at various points in a manufacturing process.

Second, the court in *Piche* expected the Commissioner to take a discerning look at the time of his review in deciding whether penalties should be imposed. See *Piche*, 152 Vt. at 229. In reviewing Appellants' case, the Commissioner showed in the Determination that he did not interpret the statute as requiring him to undertake an "individual review upon appeal to the Commissioner." The Commissioner, instead of "choosing to exercise his discretionary authority as granted under the statute," construed the penalty provision of the law to require automatic imposition of penalties unless the taxpayers met a burden to bring their case within two categories. In doing so, he was abdicating his responsibility to exercise discretion. In *Piche*, the Vermont Supreme Court stated that even in the income tax context the Commissioner was expected to subject a penalty to "individual review." *Id.* at 234. The need for the Commissioner to do this is at least equally compelling in reviewing a penalty for use tax in a manufacturing context.

While it is reasonable for the Department to establish guidelines and policies with respect to penalties in order to develop consistency, having a policy for consistency in internal Department practice at the level of a field audit or supervisory oversight, with discretion to be exercised later by a supervisor and by the Commissioner upon review,[8] is not the same as interpreting the statute to require blanket penalty imposition, and shifting to the taxpayer the burden of proof to obtain a waiver within narrow limits, with the Commissioner exercising *no* discretion upon review. Such a practice does not constitute a manner of exercising discretion, but amounts to the misuse of discretionary power in an arbitrary manner inconsistent with legislative intent. The Commissioner construed the statute as mandating the practice, and the court concludes this is an erroneous interpretation of the law. Because the Commissioner erroneously applied the law in the Determination, the decision of the Commissioner must be reversed.[9]

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[8]See quotation from *Piche v. Department of Taxes*, 152 Vt. 229 (1989) set forth above.

[9]The court agrees with Appellants that it was improper for the Commissioner to rely on Opinion 162 dated March 5, 1992, a Department opinion regarding administration of the amended penalty statute, since that Opinion was not part of the record of the hearing before the Commissioner. The Appellants had not had the opportunity to address it. While the Commissioner relies on *In re Hardy*, 144 Vt. 610 (1984) for the principle that notice may be taken of a judicially cognizable fact at any stage of an administrative proceeding, an opinion that

The court is mindful that in reviewing an administrative agency decision, deference is usually granted to the agency's interpretations of matters within its area of expertise. See *Twenty-Four Electric Utilities*, 160 Vt. at 233. The interpretation of a statute granting discretionary authority for imposing a penalty, however, is not a matter peculiarly within the knowledge and expertise of the Department of Taxes. Indeed, it is the type of subject matter with which courts are familiar. Where, as here, the agency interpretation of the statute does not involve a specialized understanding of the subject matter, and where it is contrary to statutory language and purpose and results in systematic burdening of taxpayers with what amounts to a 25% tax surcharge, it is the responsibility of the court to act to reverse an erroneous interpretation of the law.

The next question is whether the proper course for the court is simply to reverse the Commissioner's Determination on this issue and order that the penalties be refunded, or remand to the Commissioner to exercise discretion in the imposition of penalties. The court is unable to conclude that the Commissioner abused his discretion as applied to specific issues, because he construed the statute to preclude the exercise of it. The Commissioner should therefore have the opportunity to exercise discretion with respect to the penalties. The court cannot substitute its own discretion for that of the Commissioner and either uphold or refund paid penalties for its own reasons. The role of the court is to allow the department to cure the problem. The means is by vacating the determination of penalty assessment, and remanding to the Commissioner for further consideration. See *Conservation Law Found. v. Burke*, 162 Vt. 115, 128-29 (1994). Therefore, the issue is remanded to the Commissioner for the exercise of discretion, in view of the construction of the statute set forth herein.

In order to prevent an unnecessary second appeal, the court will address an issue likely to present itself on remand. It is not sufficient for the Commissioner to simply repeat the auditor's broad-brush conclusion that because the taxpayers routinely pay use tax, then any and all underreporting of use tax justifies a penalty. The record shows that the Appellants made arguments that there were various categories of underreported use tax, and that the considerations

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the Commissioner recognizes as an internal Department document (See Determination at 22 n.3.) is not judicially cognizable. It does not meet the standard of V.R.E. 201(b) that it is generally known or capable of being known by persons outside the Department. An internal administrative opinion is not the same as agency regulations promulgated pursuant to statutory authority. Furthermore, the Appellants did not have the opportunity to be heard, as required by V.R.E. 201(e). The fact that the Liquor Control Board was permitted to take judicial notice of in *Hardy*, 144 Vt. at 610, was the licensee's own record of past infractions, with which the licensee could be expected to be familiar. Thus, the case does not support the Commissioner's decision in this case to take notice of an internal Department administrative memo which the Appellants had no opportunity to address prior to receipt of the Commissioner's Determination. Also, Opinion 162 addresses Department policy related to the income tax, yet the Commissioner applied it to the different circumstance of use taxation in a manufacturing context without giving the Appellants the opportunity to address its applicability.

were different for each of the categories. In the exercise of discretion on remand, it is incumbent on the Commissioner to consider and evaluate the Appellants' claims as to the separate categories, and to make judgments concerning the imposition of penalties as to each category. Discretion exercised in such a manner is unlikely to lead to a judicial determination that discretion has been abused.

ORDER

For the reasons stated above, the Commissioner's Determination is reversed on the issue of self-generated electricity used in manufacturing, and the Appellants are entitled to a refund of taxes and interest paid. The Determination is reversed and vacated on the issue of penalties. The case is remanded to the Department for the Commissioner to exercise discretion on the appropriateness of penalties in relation to the reasons for underreporting of the use tax for the period after June 19, 1991.

Dated this 25th day of October, 1999.

Mary Miles Teachout

Hon. Mary Miles Teachout
Superior Judge