

STATE OF NORTH CAROLINA
COUNTY OF WAKE

BEFORE THE
SECRETARY OF REVENUE

IN THE MATTER OF:

The Proposed Assessment of Sales and Use)
Tax for the period January 1, 2000 through)
December 31, 2002 by the Secretary of)
Revenue of North Carolina)
)
)
 vs.)
)
 [Taxpayer])

FINAL DECISION
Docket No. 2003-442

This matter was heard before the Assistant Secretary of Administrative Hearings, Eugene J. Cella, in the City of Raleigh, on December 4, 2003, upon application for hearing by the taxpayer wherein it protested the proposed assessment of tax, penalty and interest for the period January 1, 2000 through December 31, 2003. The hearing was held by the Assistant Secretary pursuant to the provisions of G.S. 105-260.1. Representing the Sales and Use Tax Division were W. Timothy Holmes, Assistant Director, and W. C. Shelton, Administration Officer. The Taxpayer was represented by [a consultant with a consulting firm].

Pursuant to G.S. 105-241.1, the Department mailed a Notice of Sales and Use Tax Assessment to the Taxpayer on February 18, 2003 assessing tax, penalty and interest in the amount of \$60,864.20. The Taxpayer objected to the proposed assessment and timely requested a hearing.

ISSUES

The issues to be decided are:

1. Did the Taxpayer purchase non-taxable advertising services or taxable tangible personal property (printed material) for distribution in North Carolina?
2. Are the pre-stamped envelopes containing printed material which is brought into North Carolina for distribution to donees considered taxable or non-taxable out-of-state distribution?

EVIDENCE

The following items were introduced into evidence by the Sales and Use Tax Division:

1. Copy of Memorandum dated May 16, 2001 from the Secretary of Revenue to the Assistant Secretary of Tax Administration, designated Exhibit E-1.
2. Copy of sales and use tax auditor's report for the period January 1, 2000 through December 31, 2002 dated February 7, 2003, designated Exhibit E-2.
3. Copy of Notice of Sales and Use Tax Assessment dated February 18, 2003, designated Exhibit E-3.
4. Copy of letter dated March 18, 2003 and attachment from the Taxpayer's representative to the Department of Revenue, designated Exhibit E-4.
5. Copy of letter dated April 10, 2003 from the Sales and Use Tax Division to the Taxpayer's representative, designated Exhibit E-5
6. Copy of letter dated April 28, 2003 from the Taxpayer's representative to the Sales and Use Tax Division, designated Exhibit E-6.
7. Copy of letter dated April 30, 2003 from the Taxpayer's representative to the examining auditor, designated Exhibit E-7.
8. Copy of letter dated May 8, 2003 from the Sales and Use Tax Division to the Taxpayer's representative, designated Exhibit E-8.
9. Copy of letter dated June 3, 2003 from the Taxpayer's representative to the Sales and Use Tax Division, designated Exhibit E-9.
10. Copy of letter dated June 9, 2003 from the Sales and Use Tax Division to the Taxpayer's representative, designated Exhibit E-10.
11. Copy of letter dated June 20, 2003 from the Taxpayer's representative to the Sales and Use Tax Division, designated Exhibit E-11.
12. Copy of letter dated July 31, 2003 from the Taxpayer's representative to the Sales and Use Tax Division and the following attachments, designated Exhibit E-12 (a, b, c & d).
 - (a) Attachment #1: Franchise agreement between the Taxpayer and the [Franchisor].
 - (b) Attachment #2: [Invoice number] dated 1/8/2001 from the Franchisor to the Taxpayer.
 - (c) Attachment #3: Sample bill of lading between the Franchisor and a related franchisee.
 - (d) Attachment #4: Sample consolidated mailing statement for a 2001 North Carolina distribution obtained from the Franchisor.

13. Copy of letter dated August 22, 2003 from the Sales and Use Tax Division to the Taxpayer's representative, designated Exhibit E-13.
14. Copy of Court of Appeal of Florida, Second District, Case No. 2 DO2-2596 dated June 27, 2003, designated Exhibit E-14.
15. [Sample advertising envelope] and enclosed coupons, designated Exhibit E-15.
16. Copy of Sales and Use Tax Technical Bulletin 24-1 dated June 1, 2002, designated Exhibit E-16.
17. Copy of letter dated October 20, 2003 from the Assistant Secretary of Revenue to the Taxpayer's representative, designated Exhibit E-17.
18. Copy of letter incorrectly dated July 31, 2003 from the Taxpayer's representative sent by facsimile to the Assistant Secretary of Revenue on October 30, 2003, designated Exhibit E-18.
19. Copy of letter dated October 31, 2003 from the Taxpayer's representative to the Assistant Secretary of Revenue, designated Exhibit E-19.
20. Copy of letter dated November 3, 2003 from the Assistant Secretary of Revenue to the Taxpayer's representative, designated Exhibit E-20.
21. Copy of Supreme Court Opinion, Docket Number S-94-428, dated April 5, 1996, Supreme Court of Nebraska, designated Exhibit E-21.
22. Copy of G.S. 25-2-401. Passing of title; reservation for security; limited application of this section, designated Exhibit E-22.

The following exhibits were submitted by the parties during or after the administrative hearing on December 4, 2003.

23. Brief for Tax Hearing, dated December 4, 2003 from the Sales and Use Tax Division to the Assistant Secretary for Tax Administration, designated Exhibit E-23.
24. Brief for Tax Hearing, dated December 4, 2003 from the Taxpayer's representative to the Assistant Secretary for Tax Administration, designated Exhibit E-24.
25. Addendum to the Brief, dated December 17, 2003 from the Taxpayer's representative to the Assistant Secretary for Tax Administration, designated Exhibit E-25.
26. Memorandum, dated December 30, 2003 from the Sales and Use Tax Division to the Assistant Secretary for Tax Administration, designated Exhibit E-26.

FINDINGS OF FACT

Based on the foregoing evidence of record, the Assistant Secretary makes the following findings of fact:

1. The Taxpayer is an independent franchisee of [Franchisor]. [The Franchisor] publishes, prints, and assembles [envelopes] at its [out-of-state facility].
2. The Taxpayer solicits clients and distributes the [envelopes] containing the coupons and fliers to recipients in [North Carolina].
3. [Franchisor] utilizes a contract carrier to ship the bulk stuffed envelopes containing coupons and fliers into North Carolina where they are committed to the U. S. Mail in [an area located in North Carolina] for delivery to the homes of the Taxpayer's clients' prospective customers.
4. Prior to January 1, 2002, the Franchisor did not commit printed matter to the U. S. Mail outside of North Carolina. Instead, they hired a contract carrier to transport the printed matter into North Carolina where it was mailed in [an area located in North Carolina]. Mail which was committed to the U. S. Mail outside of North Carolina was not subjected to tax for the period January 1, 2000 through December 31, 2001.
5. The U. S. Postal Service did not have dominion and control over the contract carrier which was hired by [Franchisor].
6. Multiple pallets of stuffed envelopes represent tangible personal property and not "advertising services."
7. The essence or "true object" of what the Franchisor conveyed, in substance, in exchange for consideration paid by the Taxpayer is taxable tangible printed matter which the Taxpayer owned and used in North Carolina fulfilling the definition of "use."
8. The purchase of the stuffed envelopes is a purchase of taxable tangible personal property rather than "advertising services" or a franchise fee.
9. Taxable tangible personal property is what is placed on the contract carriers trucks for delivery into North Carolina in fulfillment of the Taxpayer's contractual obligations to its clients.
10. The Taxpayer makes solicitations and sales to clients in [North Carolina], receives the Franchisor's invoice for the printed matter, then remits payment to the Franchisor at some time after the printed matter is brought into North Carolina.
11. The Notice of Proposed assessment was mailed to the Taxpayer on February 18, 2003.
12. The Taxpayer notified the Department that it objected to the assessment and timely requested a hearing.

CONCLUSIONS OF LAW

Based on the foregoing findings of fact, the Assistant Secretary of Revenue makes the following conclusions of law:

1. Under the McNamara v. D. H. Holmes Co., Ltd Supreme Court case, catalogs printed by a nonresident printer for a Louisiana resident corporation which were mailed outside of Louisiana to resident recipients were considered taxable. The Sales and Use Tax Division did not follow this determination and did not tax the Taxpayer on similar transactions prior to January 1, 2002.
2. G.S. 105-164.3(46) define “Tangible personal property” to include “Personal property that may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses. . . .” The stuffed envelopes purchased by the Taxpayer are personal property which can be weighed, measured, felt and touched.
3. Prior to January 1, 2002, amounts designated for postage, if separately stated, are not subject to sales or use tax for printed matter which was brought into North Carolina to be mailed to North Carolina recipients.
4. Effective January 1, 2002, the definition of “use” in G.S. 105-164.3(18) and G.S. 105-164.3(49) (effective January 1, 2002) includes “ . . . any withdrawal from storage, distribution, installation, affixation to real or personal property, or exhaustion or consumption of tangible personal property by the owner or purchaser thereof, . . .” The addition of the word “distribution” (effective January 1, 2002) means that postage is a part of the tax base for sales and use tax purposes.
5. The Taxpayer is liable for the use tax based on its “use” of the taxable tangible personal property in North Carolina pursuant to G.S. 105-164.3(18) and (49).
6. The Notice of Proposed assessment was issued to the Taxpayer pursuant to G.S. 105-241.1.

DECISION

The Taxpayer is an independent franchisee of [Franchisor], which is a subsidiary of [Parent Company]. [The Franchisor] publishes, prints, and assembles the [envelopes] which contain advertising coupons of interest distributed to potential recipients in [an area located in North Carolina]. The Taxpayer solicits clients and distributes the [envelopes] containing coupons and fliers to recipients in [North Carolina].

The envelopes were printed, addressed and postage was applied [out-of-state] using the Postal Permit Number of the Franchisor. The Franchisor prepares the mail under a U. S. Postal Service procedure known as the Plant Verified Drop Shipment. A Postal Service employee is

stationed at the Franchisor's facility for several purposes, one of which is that the bulk mailings meet U. S. Postal Service regulations. The employee confirms the amount of postage due and receives payment for the postage from the Franchisor. The mail is loaded onto a truck which has been hired by the Franchisor and U. S. Postal service documents are placed in the truck after it is verified that the postage has been paid. The Franchisor utilizes a contract carrier for this shipment since they receive a discount on postage charges when they bear the costs of the shipment into North Carolina. Once the mail reaches North Carolina, it is mailed in [a North Carolina area] for delivery to the homes of the Taxpayer's clients' prospective customers.

The Taxpayer contends that they actually purchase only non-taxable advertising services basing their claim on the nature of the Franchise agreement between the Franchisor and the Taxpayer. They also assert that the Taxpayer distributes [envelopes] free to the public and that it does not "sell" the envelopes. Since they are only selling advertising services, they contend that it follows that they cannot be purchasing printed material from the Franchisor. The Taxpayer asserts that the relationship between the parties is that the Franchisor is the publisher of the free distribution [envelopes] and the Taxpayer sells advertising in the [envelopes] in its geographic area. The Taxpayer also contends that there is no transfer of title of the [envelopes] to the Taxpayer in North Carolina. They believe that ownership is ultimately transferred by a transfer of possession to the recipient from the Franchisor. The Taxpayer illustrates this argument with their explanation and discussion of "constructive possession" claiming that it never has possession or "constructive possession" of the [envelopes]. According to the Taxpayer, the transfer of ownership of the [envelopes] is effected by a transfer of possession rather than a transfer of title. Further, they contend that they never "use" the envelopes because they do not purchase them.

Another objection raised by the Taxpayer is that distribution from out-of-state is not a taxable use in North Carolina prior to January 1, 2002. The Taxpayer is referring to the Sales and Use Tax Division's policy of not proposing to tax catalogs or other printed matter committed

to the U. S. Mail outside of North Carolina prior to January 1, 2002. Under that policy, in the McNamara v. D. H. Holmes Co., Ltd. case, the Sales and Use Tax Division chose not to follow the Supreme Court's determination that sales of catalogs by a nonresident printer to a Louisiana resident corporation which were mailed outside of Louisiana to resident recipients were considered taxable. Effective January 1, 2002, the definition of "use" in G.S. 105-164.3(49) includes ". . . any withdrawal from storage, distribution, installation, affixation to real or personal property, or exhaustion or consumption of tangible personal property by the owner or purchaser thereof, . . ." (emphasis added)

Pursuant to the above statutory change, prior to January 1, 2002, the amounts designated for postage, if separately stated, are not subject to tax for printed matter which was brought into North Carolina to be mailed to North Carolina recipients. However, since January 1, 2002, the Sales and Use Tax Division responds that retailers, purchasers or franchisees who engage out of state printers to print and mail printed material to North Carolina designees are liable for the use tax on the delivered price of the printed material. The amounts spent by a vendor or vendee on postage represent charges for distribution of the printed matter and are taxable since January 1, 2002.

Based on the McNamara v. D. H. Holmes Co. Ltd., Supreme Court case, any mail sent to North Carolina recipients which was committed to the U. S. Mail outside of North Carolina prior to January 1, 2002 was not subjected to tax in the audit period. In this case, prior to January 1, 2002, the printed matter was not committed to the U. S. Mail outside of North Carolina for mailing to North Carolina recipients. Instead, [the printer] hired a contract carrier to transport the printed matter into North Carolina. Once the pallets of envelopes arrived in North Carolina, they were then committed to the U. S. Mail in the Raleigh area. According to the Sales and Use Tax Division, the fact that a U. S. Postal Service employee located at the [out of state detached mail unit] examined the stuffed envelopes and authorized their mailing does not meet the requirement that the property be committed to the U. S. Mail. The Sales and Use Tax

Division contends, and I agree, that the U. S. Postal Service did not have dominion and control over the contract carrier which was hired by the Franchisor. Rather, the U. S. Postal service had dominion and control when the bulk stuffed envelopes were placed into the mail in the [area located in North Carolina] for delivery to prospective customers of the Taxpayer's clients.

The Taxpayer makes elaborate references to the agreement between the Franchisor and the Taxpayer claiming that this agreement merely sets forth an exchange of "advertising services" for consideration. However, neither the Franchisor nor the Taxpayer can contract away a statutory sales or use tax liability. G.S. 105-164.3(46) defines "Tangible personal property" to include " Personal property that may be seen, weighed, measured, felt, or touched or is in any other manner perceptible to the Senses. . . ." The stuffed envelopes purchased by the Taxpayer are personal property which can be weighed, measured, felt and touched as defined in the definition of "tangible personal property." A reasonable and disinterested observer would not view the multiple pallets of stuffed envelopes and make any other determination but that they are tangible personal property and not "advertising services."

G.S. 105-164.3(18) and G.S. 105-164.3(49) (effective January 1, 2002) provide, in part, that "Use' means and includes the exercise of any right or power or dominion whatsoever over tangible personal property by a purchaser thereof" (emphasis added). The essence of what the Franchisor conveyed, in substance, in exchange for consideration paid by the Taxpayer is taxable tangible printed matter and the Taxpayer owned and used the property in North Carolina fulfilling the definition of "use". It is a well-established principal in the Sales and Use Tax statutes that one need not have actual possession of tangible personal property in order to have ownership thereof.

I am also compelled to agree that the consideration paid by the Taxpayer to the Franchisor clearly represents a purchase of taxable tangible personal property and not for some obscure, indefinite rights to "advertising services" or a franchise fee. The stuffed envelopes are tangible and corporeal as well as owned and used by the Taxpayer in North Carolina. The

Sales and Use Tax Division dutifully poses the question: What is placed on the contract carrier's trucks [in another state] for delivery into North Carolina? In my opinion, it is printed matter, specifically stuffed envelopes, which are used by the Taxpayer and other franchisees to fulfill their contractual obligations to their clients. The true object of the transaction is the stuffed envelopes and without their delivery to the Taxpayer's clients, there would be no business operations for the Franchisor or the Taxpayer.

Therefore, the proposed assessment of tax and interest is deemed correct under the law and the facts and is hereby sustained. Because the failure to pay the tax was not the result of a negligent or intentional act by the Taxpayer, I find reasonable cause to waive the penalties. The proposed assessment of tax and accrued interest is hereby declared to be finally determined and immediately due and collectible with interest as allowed by law.

This 12th day of March, 2004.

Signature _____

Eugene J. Cella
Assistant Secretary of Administrative Hearings