

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 September 1, 1994 through)
October 31, 2000, by the Secretary of)
Revenue of North Carolina)
vs.)
[Taxpayer])

FINAL DECISION
Docket No. 2003-68

This matter was heard before the Assistant Secretary of Administrative Hearings, Eugene J. Cella, in the City of Raleigh, on March 6, 2003, upon application for hearing by the taxpayer wherein it protested the proposed assessment of tax, penalty and interest for the period September 1, 1994 through October 31, 2000. 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 Andrew Sabol III, Director, and W. C. Shelton, Administration Officer. The Taxpayer was represented by [a Taxpayer Representative and the Vice President of the Corporation].

Pursuant to G.S. 105-241.1, the Department mailed a Notice of Sales and Use Tax Assessment to the Taxpayer on January 24, 2001 assessing tax, penalty and interest in the amount of \$25,545.11. The Taxpayer objected to the proposed assessment on February 5, 2001 and timely requested a hearing.

ISSUE

The issue to be decided is:

Are the Taxpayer's purchases of equipment used in its terminaling contract with [Company Two] and bagging contract with [Company One] subject to the 1% State preferential rate of tax?

EVIDENCE

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

1. Copy of memorandum dated May 16, 2001, from the Secretary of Revenue to the Assistant Secretary of Administrative Hearings, designated as Exhibit E-1.

2. Copy of AS/RP-1 Application For Sales and Use Tax Registration for Taxpayer dated November 1, 2000, designated Exhibit E-2.
3. Copy of Memorandum dated November 27, 2000 from the President of Taxpayer corporation to the examining auditor, designated Exhibit E-3.
4. Copy of audit report dated January 11, 2001, designated Exhibit E-4.
5. Copy of Notice of Sales and Use Tax Assessment dated January 24, 2001, designated Exhibit E-5.
6. Copy of letter dated February 5, 2001, from the Taxpayer to the Department of Revenue, designated Exhibit E-6.
7. Copy of letter dated March 7, 2001 from the Sales and Use Tax Division to the Taxpayer's representative, designated Exhibit E-7.
8. Copy of letter dated June 6, 2001 from the Sales and Use Tax Division to the Taxpayer's representative, designated Exhibit E-8.
9. Copy of letter dated June 22, 2001, from the Taxpayer's representative to the Sales and Use Tax Division, designated Exhibit E-9.
10. Copy of letter dated September 17, 2001, from the Sales and Use Tax Division to the Taxpayer, designated Exhibit E-10.
11. Copy of letter dated September 19, 2002, from the Sales and Use Tax Division to the Taxpayer's representative, designated Exhibit E-11.
12. Copy of undated summary of notes on contracts for [two companies] designated Exhibit E-12.
13. Copy of letter dated November 28, 2000 from [Company One] to the President of Taxpayer corporation, designated Exhibit E-13.
14. Copy of Contract Amendment dated May 12, 1999 from [Company Two] to the Vice-President of Taxpayer corporation, designated Exhibit E-14.
15. Copy of [Company Two] contract dated December 7, 1998 for transloading, warehousing and transportation services with Taxpayer corporation, designated Exhibit E-15.
16. Copy of [Company One] contract dated October 1, 1996 for bagging with Taxpayer corporation, designated Exhibit E-16.
17. Copy of Sales and Use Technical Bulletin 2-1 A.1., designated Exhibit E-17.
18. Copy of Sales and Use Tax Technical Bulletin 3-6 A., designated Exhibit E-18.
19. Copy of redacted Final Decision, Docket Number 2002-152, dated July 9, 2002, designated Exhibit E-19.

20. Copy of letter dated December 20, 2002 from the Taxpayer's representative to the Sales and Use Tax Division, designated Exhibit E-20.
21. Copy of letter dated January 9, 2003 from the Assistant Secretary of Revenue to the Taxpayer's representative, designated Exhibit E-21.

The Taxpayer's representative introduced the following evidence into evidence at the hearing:

22. Brief, dated March 6, 2003 prepared by the Taxpayer's representative, designated Exhibit TP-1.
23. Copy of Sales and Use Tax Field Auditor's report dated January 11, 2001, designated Exhibit TP-2.
24. Copy of Power of Attorney and Declaration of Representative dated May 10, 2001, designated Exhibit TP-3.
25. Copy of letter dated May 7, 2001 from the Sales and Use Tax Division to the Taxpayer, designated Exhibit TP-4.
26. Copy of letter dated June 22, 2001 from the Taxpayer's representative to the Sales and Use Tax Division, designated Exhibit TP-5.
27. Copy of letter dated September 19, 2002 from the Sales and Use Tax Division to the Taxpayer's representative, designated Exhibit TP-6.
28. Copy of letter dated January 9, 2003 from the Assistant Secretary of Revenue to the Taxpayer's representative, designated Exhibit TP-7.
29. Copy of [Company Two] Contract Amendment Number 1 dated April 15, 1999, designated Exhibit TP-8.
30. Copy of letter dated November 28, 2000 from [Company One] Corporation to the Taxpayer, designated Exhibit TP-9.
31. Copy of [color brochure and enclosed attachments], designated Exhibit TP-10.

FINDINGS OF FACT

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

1. The Taxpayer is a corporation which provides bagging, warehousing, transportation and transloading services for customers.
2. The Taxpayer also operates as a contract manufacturer of plastic bottles and other products for various manufacturers.

3. The additional tax due resulted from the failure of the Taxpayer to accrue and remit the 4% State and 2% local use tax on its purchases of equipment made from out-of-state vendors not registered to collect North Carolina sales and use taxes.
4. The Taxpayer has terminaling contracts with [two different chemical manufacturers].
5. The Taxpayer performs screening, sizing and bagging operations on the chemicals at their facility which is separate and apart from the chemical manufacturers' facilities.
6. In the contract with [Company One], the Taxpayer is required to receive chemicals that have been processed into powder or granulated form, store the chemicals and then to repackage them into bags and prepare the chemicals for sale and ultimate delivery to [Company One's] customers.
7. The chemicals must go through a screening process prior to being bagged for shipment and the screening process takes place within a silo.
8. The product is bagged into fifty-pound bags. The bags are then palletized and prepared for shipment either to [Company One's] plant or to such other locations as may be designated by [Company One].
9. In the [Company One] contract, there is no specific description of how these services will be performed, other than the requirement for the Taxpayer to ". . . store, load and arrange for shipment of the bagged product to [Company One's] plant or to such other designations as may be designated by [Company One]. . . and to provide all operations, labor, equipment, tools, machinery, facilities, supplies and materials necessary or appropriate for the Taxpayer's performance hereunder."
10. In the second contract with [Company Two], the issue is similar to the one with [Company One]; however, in the [Company Two] contract, the Taxpayer is also required to withdraw samples of the products and forward them to [Company Two] for analysis.
11. The Taxpayer performs no analysis of the chemical products but provides the chemicals to [Company Two] for their analysis under the terms of the contract.
12. Under the two contracts, the product which leaves the Taxpayer's premises is the same product which enters the Taxpayer's terminal at the beginning of the screening, sizing and bagging process.
13. At no time does the Taxpayer own the chemicals which they screen, size and bag.
14. The distribution phase of the manufacturing process has begun when the finished chemicals leave the chemical manufacturers' facilities.
15. The Taxpayer is performing a contracted service for chemicals which they do not own pursuant to the terms of their contracts with chemical manufacturers.
16. The Notice of Proposed assessment was mailed to the Taxpayer on January 24, 2001.
17. The Taxpayer notified the Department that it objected to the assessment on February 5, 2001 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. G.S. 105-164.4A(2) provides, in part, for the 1% State rate of tax with an \$80.00 maximum tax per article on “Sales of mill machinery or mill machinery parts and accessories to manufacturing industries and plants, and sales to contractors and subcontractors purchasing mill machinery or mill machinery parts and accessories for use by them in the performance of contracts with manufacturing industries and plants, . . .”
2. Sales and Use Tax Technical Bulletin 2-1 A.1. provides, in part, that “. . . Production does not include any activity connected with the movement of raw materials or ingredients into inventory nor does it include distribution as defined in Subparagraph A. 2. of this Bulletin. . . .” “Distribution’ with reference to industrial and manufacturing plants shall mean any activity connected with the movement of manufactured products within storage warehouses, shipping rooms and other such finished products storage areas and the removal of such products therefrom for sale or shipment. . . .”
3. Sales and Use Tax Technical Bulletin 3-6 A. provides, in part, that “. . . Machinery and equipment used in the shipping room, warehouse or other locations separate and apart from the manufacturing process to prepare property for shipment is subject to the general rate of State tax and any applicable local sales and use tax.”
4. There is no definition of manufacturing in the Sales and Use Tax statutes.
5. In Duke Power Co. v. Clayton, 274 N.C. 505, 164 S. E.2d (1968, “manufacturing” is defined as “The producing of a new article or use or ornament by the application of skill and labor to the raw materials of which it is composed” and as “The making of a new product from raw or partly wrought materials.”
6. In Sayles Biltmore Bleacheries, Inc. v. Johnson, a manufacturer is defined as “one who changes the form of a commodity, or who creates a new commodity.”
7. In Master Hatcheries, Inc. v. Coble, the use of complicated precision equipment is used along with the “application of skill and labor to the raw material.”
8. The Taxpayer’s terminaling, screening and bagging operations for both chemical manufacturers fall outside the purview of the partial exemption set forth in G.S. 105-164.4A(2).
9. The Taxpayer is liable for the applicable general State and local additional tax.
10. The Notice of Proposed assessment was mailed to the Taxpayer on January 24, 2001.
11. The Taxpayer notified the Department that it objected to the assessment on February 5, 2001 and timely requested a hearing.

DECISION

The Taxpayer is a corporation which provides contract bagging, warehousing, transportation and transloading services for customers. The Taxpayer also has other contracts to provide contract manufacturing services for plastic bottle firms and other manufacturers. At issue is the use tax assessed on the equipment purchased and used by the Taxpayer pursuant to their fulfillment of the terms of two terminaling contracts with [two companies].

In the first contract with [Company One], the Taxpayer receives powdered or granulated chemicals, briefly stores, then repackages the chemicals into bags for ultimate delivery to the chemical manufacturer's customers. The Taxpayer receives the chemicals in trucks which are pumped into a silo located outside the Taxpayer's facility. The chemicals are screened prior to being placed into the bags and it is during this procedure that the chemicals are sized to meet the specifications of the chemical manufacturer's customers. The product is bagged into fifty-pound bags which are palletized and prepared for shipment to the chemical manufacturer or to its designated customers.

In the second contract with [Company Two], the Taxpayer also screens the chemicals as in the first contract but they are also required to withdraw samples of the chemicals for the chemical manufacturer to analyze. The Taxpayer does not perform the analysis but provides the chemicals to the manufacturer for their own analysis.

The Department has levied use tax at the general rate of tax on the equipment purchased and used in the Taxpayer's terminaling, bagging, sampling and screening operations pursuant to their contracts with the chemical manufacturers.

The Taxpayer argues that the screening and sampling procedure is a function of quality control and therefore the equipment utilized in these functions should be subject to the 1% State preferential rate of tax. In their opinion, the Taxpayer "stands in the shoes" of the chemical manufacturers by providing the screening, bagging and sampling services pursuant to their contracts with manufacturers. They argue that since the Taxpayer also operates as a contact

manufacturer for other manufacturing processes and because 70% of the firm's revenues are derived from processes on which the 1% State tax rate is applicable, then likewise the equipment used in the terminaling contracts with the chemical manufacturers should be subject to the 1% State preferential rate of tax. It is not disputed that the equipment in question is not utilized in the Taxpayer's operations as a contract manufacturer for plastic bottles and other items.

G.S. 105-164.4A(2) provides for the 1% State rate of tax with an \$80.00 maximum tax per article on "Sales of mill machinery or mill machinery parts and accessories to manufacturing industries and sales to contractors and subcontractors purchasing mill machinery or mill machinery parts and accessories for use by them in the performance of contracts with manufacturing industries and plants. . . ."

There is no definition of "manufacturing" per se in the Sales and Use Tax Statutes. The Sales and Use Tax Division relies upon the following court cases to guide its determinations on what types of firms constitute manufacturing operations. In Duke Power Co. v. Clayton, 274 N.C. 505, 164 S.E.2d 289 (1968), "manufacturing" is defined as "The producing of a new article or use or ornament by the application of skill and labor to the raw materials of which it is composed" and as "The making of a new product from raw or partly wrought materials." In Sayles Biltmore Bleacheries, Inc. v. Johnson, 266 N.C. 692, 147 S.E.2d 177 (1966), a manufacturer is defined as "one who changes the form of a commodity, or who creates a new commodity." In Master Hatcheries, Inc. v. Coble, 286 N.C. 518, 212 S.E.2d 150, (1975) the use of complicated precision equipment is used along with the "application of skill and labor to the raw material (egg) to create a new and more valuable property (chicks)."

I must agree with the Sales and Use Tax Division's position that the Taxpayer does not create a "new product from raw or partly wrought materials" as the court opined in Duke Power Co. v. Clayton. I also do not believe that the Taxpayer "changes the form of a commodity", or that the Taxpayer's process "creates a new commodity." (Sayles). Nor does the Taxpayer

“create a new and more valuable property.” (Master Hatcheries) The product which leaves the Taxpayer's premises is the same product which enters the Taxpayer's terminal at the beginning of the screening, sampling and bagging process. The fact that the Taxpayer withdraws sample chemicals for analysis under the terms of the contract with [Company Two] has no bearing on the determination of the rate of tax on the Taxpayer's equipment. The Taxpayer performs no analysis of the product itself but instead provides the chemicals to the manufacturer for their analysis. At no time does the Taxpayer own the chemicals which are received and prepared for shipment.

It is also my opinion that the production process has been concluded and the distribution phase of the manufacturing process has begun when the finished chemicals leave the chemical manufacturers' facilities. Thus, the general rate of sales and use tax would apply to all equipment used after the final step of the production process. The Taxpayer is merely performing a contracted service for goods which he does not own pursuant to the explicit terms of the contracts with the chemical manufacturers.

The Taxpayer's operations simply fall outside the purview of the partial exemption set forth in G.S. 105-164.4A(2). The courts have held that any taxpayer claiming an exemption or exception from tax has the burden of bringing himself within the exemption or exception since exemptions or exceptions from taxes must be construed in favor of the taxing power. In Sale v. Johnson, 258 N.C. 749, 129 S.E.2d 465 (1963), the courts ruled, “Statutes providing exemption from taxation are strictly construed.” The courts also ruled in Hatteras Yacht Co. v. High, 265 N.C. 653, 144 S.E.2d 821 (1965), that “Provisions in a tax statute granting exemptions from the tax thereby imposed are to be strictly construed in favor of the imposition of the tax and against the claim of exemption.”

In Final Decision Docket Number 2002-152, the Assistant Secretary of Revenue sustained the Sales and Use Tax Division's position that a firm which repackages bulk vitamins, drugs and other pharmaceuticals into bubble wrap type packaging is not a manufacturer. Thus,

the firm was not entitled to the 1% State preferential rate of tax on its purchases of equipment used in the firm's repackaging services. I believe that the Taxpayer's terminaling, screening, sampling and bagging operations are similar to the Taxpayer's packaging operations in Final Decision 2002-152 in that the final step of the production process has occurred at the chemical manufacturers' facilities and before the property arrives at the Taxpayer's facilities.

Therefore, the assessment of tax, penalty and interest, per the Notice of Sales and Use Tax Assessment, is sustained, and declared to be final and immediately due and collectible.

This 4th day of June 2003.

Signature _____

Eugene J. Cella
Assistant Secretary of Administrative Tax Hearings