

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 October 1, 1997 through)
July 31, 2001, by the Secretary of)
Revenue of North Carolina)
vs.)
[Taxpayer])

FINAL DECISION
Docket No. 2002-152

This matter was heard before the Assistant Secretary of Administrative Hearings, Eugene J. Cella, in the City of Raleigh, on May 16, 2002, upon application for hearing by the taxpayer wherein it protested the proposed assessment of tax, penalty, and interest for the period October 1, 1997 through July 31, 2001. 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 manager 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 October 11, 2001 assessing tax, penalty, and interest in the amount of \$54,874.65. The Taxpayer objected to the proposed assessment in a letter dated November 8, 2001 and timely requested a hearing.

ISSUES

The issue to be decided in this matter is as follows:

Is the Taxpayer a manufacturer and thus entitled to the 1% State rate of tax with an \$80.00 maximum tax per article on its purchases of mill machinery, mill machinery parts, and accessories?

EVIDENCE

The following items were introduced into evidence by the Sales and Use Tax Division of the Department of Revenue at the hearing:

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 AS/RP-1 Application For Sales and Use Tax Registration for Taxpayer dated January 19, 1998, designated Exhibit E-2.
3. Copy of face sheet of audit report and auditor's comments dated September 28, 2001, designated Exhibit E-3.
4. Copy of Notice of Sales and Use Tax Assessment dated October 11, 2001, designated Exhibit E-4.
5. Copy of letter dated November 8, 2001 from the Taxpayer to the Department of Revenue, designated Exhibit E-5.
6. Copy of letter dated November 30, 2001 from the Sales and Use Tax Division to the Taxpayer, designated Exhibit E-6.
7. Copy of letter dated December 13, 2001 from the Taxpayer to the Sales and Use Tax Division, designated Exhibit E-7.
8. Copy of letter dated December 18, 2001 from the Sales and Use Tax Division to the Taxpayer, designated Exhibit E-8.
9. Copy of letter dated January 18, 2002 from the Taxpayer to the Sales and Use Tax Division, designated Exhibit E-9.
10. Copy of blank License Application for Wholesale Prescription Drug Distributors from the North Carolina Department of Agriculture, Food and Drug Protection Division, designated Exhibit E-10.
11. Copy of North Carolina Administrative Code Section 2 NCAC 9M .0101, designated Exhibit E-11.
12. Copy of letter dated November 29, 2001 from the North Carolina Department of Agriculture to the Sales and Use Tax Division, designated Exhibit E-12.
13. Copy of G.S. 106-145.1, Wholesale Prescription Drug Distributors, designated Exhibit E-13.
14. Copy of Sales and Use Tax Administrative Rule 17 NCAC 7B .0602, designated Exhibit E-14.
15. Copy of Sales and Use Tax Technical Bulletin 3-6A, designated Exhibit E-15.
16. Copy of letter dated January 29, 2002, from the North Carolina Department of Agriculture, Food and Drug Protection Division, designated Exhibit E-16.
17. Sample packets of packaged non-prescription drugs, designated Exhibit E-17.
18. Copy of letter dated February 18, 2002, from the Assistant Secretary of Revenue to the Taxpayer's representative, designated Exhibit E-18.

19. Copy of letter dated February 27, 2002, from the Assistant Secretary of Revenue to the Taxpayer's representative, designated Exhibit E-19.
20. Copy of Brief for Tax Hearing prepared by the Sales and Use Tax Division, designated as Exhibit E-20.

Evidence presented by the Taxpayer's representative at the hearing consisted of the following:

21. Taxpayer's position, published technical data regarding blister packaging, and court case summaries submitted by Taxpayer's representative, designated Exhibit TP-1.

FINDINGS OF FACT

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

1. The Taxpayer purchased pharmaceuticals, vitamins, and supplements in bulk from pharmaceutical manufacturers which were packaged in a blister container to create a unit dose punch card.
2. The Taxpayer did not produce any pharmaceuticals, vitamins, or supplements; it is not co-located with any bona-fide manufacturer; nor does it have any contracts to repackage pharmaceuticals, vitamins, or supplements with manufacturers.
3. The Taxpayer did not accrue and remit use tax on its purchases of equipment from out of state vendors that were not required to collect and remit taxes in North Carolina.
4. The Department assessed the 4% State and 2% local use tax on the Taxpayer's purchases of machinery and parts used in its operation.
5. The manufacturing process for the pharmaceuticals, vitamins, and supplements purchased by the Taxpayer for packaging was concluded when the final step of production was performed by the pharmaceutical manufacturers at their manufacturing facility.
6. The Notice of Proposed assessment was mailed to the Taxpayer on October 11, 2001.
7. The Taxpayer notified the Department that it objected to the assessment on November 8, 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. The Taxpayer was, at all material times, engaged in the business of repackaging pharmaceuticals, vitamins, and supplements and selling same.

2. Production means all steps performed in process and refining rooms, and in other quarters and departments of a plant, where conditioning, treating, or other operations are done on ingredient materials as an actual routine on a processing or assembly line turning out a new and different product.
3. In Duke Power Co. v. Clayton, 274 N.C. 505, 164 S.E.2d 289 (1968), the court determined that Manufacturing is 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.
4. 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.
5. In Master Hatcherries, 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 materials to create a new and more valuable property.
6. The classifications set up by the Food and Drug Protection Division of the North Carolina Department of Agriculture, which are based upon the Federal Food and Drug Administration guidelines, have no bearing on the statutory determinations set forth in the Sales and Use Tax Statutes in Article 5 of the Revenue Laws of North Carolina.
7. Tax is due on the packaging equipment, parts, and accessories purchased at the combined 4% State and 2% local rates of tax.
8. The additional tax assessed is presumed to be correct under G.S. 105-241.1(a), and the burden is upon the Taxpayer to overcome the presumption of correctness. The Taxpayer has failed to establish that it is indeed a manufacturer.

DECISION

The Taxpayer is a corporation engaged in the business of repackaging pharmaceuticals, vitamins, and supplements. It purchases these items in bulk; and after they are cleaned and repackaged by the Taxpayer, they are sold to long term care firms, hospitals, and the institutional marketplace. The Taxpayer's facility is temperature controlled and the products are kept sterile pursuant to Federal regulations. The pharmaceuticals, vitamins, and supplements are placed in airtight single unit and Pre-Filled Punch Cards doses, which extend the life as well as improve the efficacy of the medicine or supplement. The Taxpayer asserts that the packaging procedure itself is a manufacturing process or in the alternative, an extension of the manufacturing process of the products themselves.

The Department has proposed an assessment of the general rate of State and local use tax on the Taxpayer's purchases of packaging equipment used in the repackaging procedure at the Taxpayer's facility. There is no dispute that the pharmaceuticals, vitamins, and supplements were manufactured at a different location and by a different firm than the Taxpayer. Also, the Taxpayer had no contracts with the manufacturers of the pharmaceuticals, vitamins, and supplements to package the products.

The Department contends that the manufacturing process for the pharmaceuticals, vitamins, and supplements was concluded by the pharmaceutical manufacturers with their final step in the production of such products. The "true object" of the Taxpayer's customers' purchases was the pharmaceuticals, vitamins, and supplements and not the packaging provided by the Taxpayer. Therefore, the Taxpayer's equipment is subject to the higher general rate of State and applicable local tax with no partial exemption applicable.

The Taxpayer also contends that "The State of North Carolina has previously acknowledged that the Taxpayer is a manufacturer." The Taxpayer is referring to the license issued by the North Carolina Department of Agriculture, Food and Drug Protection Division. The license is issued pursuant to G.S. 106-145.1 (Article 12A: *Wholesale Prescription Drug Distributors*) and is issued to applicants upon completion of the prescription drug registration form and remittance of the appropriate fee to the Food and Drug Protection Division. The application form requires applicants to themselves denote the nature of their business as: (1) Manufacturer, (2) Repackager, (3) Relabeler, or (4) Distributor. An Administrative Officer with the Food and Drug Protection Division has advised the Department that in the past applicants have been primarily either a manufacturer or distributor. He has also verified in a letter that each firm determines the nature of their business and that this classification is not questioned or determined by the North Carolina Department of Agriculture. These classifications are based upon the broad classifications used by the Federal Food and Drug Administration. The

classifications also have no bearing whatsoever to the statutory determinations set forth in the Sales and Use Tax Statutes in Article 5 of the Revenue Laws of North Carolina.

The Taxpayer's analysis of G.S. 105-164.4(a)(1d) is flawed. I believe that the production process for the pharmaceuticals, vitamins, and supplements has indeed concluded when the final step of production is performed upon them at the pharmaceutical manufacturer's facility. 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)." None of the processes described above are performed by the Taxpayer on the pharmaceuticals, vitamins, or supplements which are the true object sought by its customers.

The Taxpayer argues that if it were "manufacturing" only the packaging itself then it would be afforded the preferential rate of tax and I agree. However, this is not what the Taxpayer does. It creates packaging for a finished product which it buys, repackages, and then resells, presumably for a higher price.

I find, therefore, that the proposed assessment of additional sales tax and penalty plus accrued interest is deemed to be correct under the law and the facts and is hereby sustained. Therefore, the assessment of tax, penalty, and interest is sustained, and declared to be final and immediately due and collectible.

This 9th day of July, 2002.

Signature _____

Eugene J. Cella
Assistant Secretary of Administrative Hearings