STATE OF NORTH CAROLINA | **BEFORE THE SECRETARY OF REVENUE**

COUNTY OF WAKE

IN THE MATTER OF:

The Proposed Assessment of Sales and Use Tax for the period April 1, 1999 through December 31, 2000, by the Secretary of Revenue of North Carolina

vs.

[Taxpayer]

FINAL DECISION
Docket No. 2002-502

This matter was reviewed by the Assistant Secretary of Administrative Hearings, Eugene J. Cella, upon application for hearing by the Taxpayer wherein it protested our proposed assessment of tax, penalty, and interest for the period April 1, 1999 through December 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 W. Timothy Holmes, Assistant Director, and Richard C. Stewart, Administration Officer. The Taxpayer was represented by [an attorney].

Pursuant to G.S. 105-241.1, the Department mailed a Notice of Tax Assessment [for County] Sales and Use dated February 20, 2002 to the Taxpayer, assessing tax, penalty, and interest in the amount of $14,101.69. The Taxpayer's attorney, in a letter dated March 21, 2002, objected to the assessment and timely requested a hearing before the Secretary of Revenue.

ISSUES

The issues to be decided in this matter are as follows:

1. Is the Taxpayer a manufacturer subject to the 1% State rate of tax with a maximum tax of $80.00 per article and, therefore, exempt from [the local] sales and use tax with respect to its purchases of mill machinery and mill machinery parts and accessories?

2. Are the Taxpayer's purchases of materials used to refinish steel cylinders or rolls which belong to its customers exempt from tax pursuant to G.S. 105-164.13(8) as ingredient or component parts of a manufactured product?

EVIDENCE

The following items were introduced into evidence by the parties:

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

2. Audit report dated February 2, 2002 covering the period April 1, 1999 through December 31, 2000, designated Exhibit E-2.

3. Notice of Tax Assessment [for North Carolina County] Sales and Use tax dated February 20, 2002, designated Exhibit E-3.

4. Letter dated March 21, 2002 from the Taxpayer's attorney to the Sales and Use Tax Division, designated Exhibit E-4.

5 Letter dated April 29, 2002 from the Sales and Use Tax Division to the Taxpayer's attorney, designated Exhibit E-5.

6. Letter dated July 6, 2002 from the Taxpayer's attorney to the Sales and Use Tax Division, designated Exhibit E-6.

7. Letter dated July 9, 2002 from the Sales and Use Tax Division to the Taxpayer's attorney, designated Exhibit E-7.

8. Letter dated August 14, 2002 from the Assistant Secretary of Revenue to the Taxpayer's attorney, designated Exhibit E-8.

9. Letter dated October 31, 1994 from the Sales and Use Tax Division to the Taxpayer's representative, designated Exhibit E-9.

10. Letter dated August 8, 1995 from the Sales and Use Tax Division to the Taxpayer's representative, designated Exhibit E-10.

11. Redacted Secretary of Revenue Final Decision, Docket No. 2001-19, designated Exhibit E-11.

12. Brief for Tax Hearing prepared by the Sales and Use Tax Division, designated Exhibit E-12.

The Taxpayer presented the following information into evidence:

13. Supplemental Brief, 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 is engaged in the business of engraving steel rolls.

2. The Taxpayer engraved the print rolls with a design specified by its customers and the rolls are used by the customers to print packaging material.

3. Approximately 80% of the Taxpayer's business involves the resurfacing of rolls that are furnished and owned by its customers. The remaining 20% of the Taxpayer's business involves the manufacture and sale of new rolls which have been engraved by the Taxpayer.

4. The Taxpayer did not make any purchases of equipment or machinery during the audit period dedicated solely to the manufacture of new rolls for sale.

5. The Department disallowed Manufacturer's Certificates, Form E-575, issued by the Taxpayer to its vendors and assessed [North Carolina County] use tax upon the Taxpayer's machinery.

6. The Department issued letter rulings to the Taxpayer in 1994 and again in 1995 advising the Taxpayer's representative that the Taxpayer was providing a service when it refurbished the rolls owned by its customers. These letter rulings specifically stated that the Taxpayer was not engaged in a manufacturing operation as anticipated by the Statute and not entitled to the preferential rate of sales or use tax.

7. The notice of [North Carolina County] sales and use tax assessment was mailed to the Taxpayer on September 21, 2001.

8. The Taxpayer's attorney protested the assessment and, by letter dated March 21, 2002, timely requested a hearing before the Secretary of Revenue.

CONCLUSIONS OF LAW

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

1. For the transactions where the Taxpayer engraved cylinders belonging to its customers, the Taxpayer did not make “retail” “sales” as defined by G.S. 105-164.3(13) and 105-164.3(15), respectively.

2. The Taxpayer is not a “manufacturing industry or plant” within the meaning of G.S. 105-164.4A(2) since its principal business is the refurbishing and refinishing of the rolls which belong to its customers.

3. The Taxpayer is not entitled to the preferential 1% rate of tax with an $80.00 maximum tax on its purchases of machinery and equipment used in the resurfacing and engraving of cylinders owned by the Taxpayer's customers.

4. The Taxpayer's purchases of materials used to refinish cylinders owned by the Taxpayer's customers are subject to [North Carolina County] sales and use tax.

5. The Notice of Proposed Assessment for the period of November 1, 1997 through December 1, 2000 was issued pursuant to G.S. 105-241.1.

DECISION

The Taxpayer is engaged in the business of stripping, electroplating, and engraving print cylinders. The cylinders are engraved to customer specifications and are used by customers to print packaging materials. Approximately 80% of the Taxpayer's business involves the resurfacing of rolls that are furnished and owned by its customers. The remaining 20% of the Taxpayer's business involves the manufacture and sale of new rolls which have been engraved by the Taxpayer.

It is the Taxpayer's position that the firm's operations involve a manufacturing process in which it works a substantial change to ingredients to produce the print rolls and that the process for refurbishing the rolls owned by the customer is identical to the process of manufacturing a new roll. Therefore, the Taxpayer maintains that its purchases and leases of machinery, equipment, repair parts for machinery and equipment, chemicals and other accessories used in its processes qualify for the 1% State tax subject to a maximum tax of $80.00 per article and therefore are exempt from [North Carolina County] sales and use tax. Also, under this position, the Taxpayer continues that the materials it uses to plate the printing rolls are exempt ingredients pursuant to G.S. 105-164.13(8). The Taxpayer issued Manufacturer's Certificates, Form E-575, to its vendors and did not pay [North Carolina County] sales or use tax on its purchases of materials that ultimately became a part of the completed printing roll. The tangible personal property the Taxpayer electrolytically plated, engraved, and returned to its customers was for use in the customer's printing process and not for resale. As a result of the audit, the Department issued the proposed [North Carolina County] use tax assessment based on purchases of equipment used in the refurbishing process and materials that became a part of the completed printing roll.

In support of its position, the Taxpayer cites Sayles v. Johnson, a case where the North Carolina Supreme Court addressed the issue of whether a taxpayer must own every raw material in order to be considered a manufacturer. The taxpayer in that case "operated a textile

finishing plant and finished textile goods owned by others." The courts held that the taxpayer was a "manufacturer" as anticipated by the statutes, notwithstanding that it was doing finishing work for another manufacturer and did not take title to every raw material used in the process. The Taxpayer concludes, based on Sayles v. Johnson, that it should be considered a "manufacturer," notwithstanding that it never takes title to the steel core upon which the electroplating and engraving take place.

G.S.105-164.4(a)(1d) and 105-164.4A(2) provide for the 1% State tax, subject to a maximum tax of $80.00 per article, upon purchases of mill machinery and mill machinery parts and accessories sold to a manufacturing industry or plant. Administrative Rules 17 NCAC 7B .0202(a) and .0406 set forth the Department's interpretation of the statute by defining production to include the "turning out of a finished product of manufacture" and further stipulating a producer's manufactured products must be "for sale."

In Hatteras Yacht Co. v. High, 265 N.C. 653, 144 S.E.2d 821 (1965), the court held that "A proviso in a statute taxing certain transactions at a lower rate than that made applicable in general, or providing that as to certain transactions the total tax shall not exceed a specified amount, there being no such limitation generally, is a partial exemption and is, therefore, to be strictly construed against the claim of such special or preferred treatment . . .. " In Piedmont Canteen Serv., Inc. v. Johnson, 256 N.C. 155, 123 S.E.2d 582 (1962) the court also held that "One who claims an exemption or exception from tax coverage has the burden of bringing himself within the exemption or exception . . .. " The taxpayer has not borne the burden of proving the exemption and partial exemption claimed in this case, and the decision rendered must construe the exemption and partial exemption strictly against the claim for tax exemption and in favor of the imposition of tax. (Hatteras Yacht Co., *Supra)*

With regard to Sayles v. Johnson, the Taxpayer's argument that this case is a basis to designate the Taxpayer as a manufacturer fails to consider one overriding difference. In Sayles v. Johnson, the taxpayer was operating as a contract manufacturer, processing for another

manufacturer textiles that would ultimately be sold at retail. By contrast, the Taxpayer does work on rolls that already belong to its customers, and the finished product is not resold, but used by the customer. This distinction undermines the Taxpayer's arguments that Sayles v. Johnson supports its contention that it should be considered a manufacturer.

The Taxpayer was not considered a “manufacturing industry or plant” by the Department because it did not make “sales” of a product manufactured from solely owned materials. Instead, the Department considered the Taxpayer’s receipts as nontaxable services from stripping, electroplating, and engraving customer-owned base cylinders. The administrative rules support the position that the Taxpayer is not a manufacturer entitled to the preferential 1% state tax levy on equipment and equipment parts and accessories. Also, the Taxpayer was not entitled to claim exemption for materials used to engrave the cylinders. The Department’s assessment of [North Carolina County] use tax due upon the Taxpayer’s purchases during the audit period is due.

Wherefore the assessment is sustained in its entirety, and is declared to be final and immediately due and collectible.

This 19th day of December, 2002.

Signature ___________________________________

Eugene J. Cella
Assistant Secretary of Administrative Tax Hearings