

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 November 1, 1996 through)
September 30, 2002 by the Secretary of)
Revenue of North Carolina)
)
vs.)
)
[Taxpayer])

FINAL DECISION
Docket No. 2003-443

This matter was heard before the Assistant Secretary of Revenue for Administrative Tax Hearings, Eugene J. Cella, in the City of Raleigh, on January 15, 2004, upon application for hearing by the taxpayer wherein it protested the proposed assessment of tax, penalty and interest for the period November 1, 1996 through September 30, 2002. 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 [Certified Public Accountant] and [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 3, 2003 assessing tax, penalty and interest in the amount of \$227,792.94. The Taxpayer’s representative objected to the proposed assessment and timely requested a hearing.

ISSUES

The issues to be decided in this matter are:

1. Are the Taxpayer’s individual or “solo” mailings of printed material considered tangible personal property and subject to tax and if so, is the postage considered a part of the “sales price”?

2. Are the Taxpayer's individual, "solo," mailings of printed material considered advertising services not involving the sale of tangible personal property and therefore not subject to sales or use tax?
3. Will the Department abandon the Taxpayer's proposed sales and use tax assessment because the Taxpayer relied on prior erroneous professional advice from an attorney? If yes, will the Department allow the Taxpayer to remit Sales and Use Tax prospectively on sales and purchases of tangible personal property (printed matter)?

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 Revenue for Administrative Tax Hearings, designated Exhibit E-1.
2. Sales and use tax auditors' report for the period November 1, 1996 through September 30, 2002 dated December 13, 2002, designated Exhibit E-2.
3. Notice of Sales and Use Tax Assessment dated January 3, 2003, designated Exhibit E-3.
4. Copy of letter dated January 24, 2003 from the Taxpayer's representative to the Department of Revenue, designated Exhibit E-4.
5. Copy of letter dated February 11, 2003 from the Sales and Use Tax Division to the Taxpayer's representative, designated Exhibit E-5.
6. Copy of letter dated March 17, 2003 from the Sales and Use Tax Division to the Taxpayer's representative, designated Exhibit E-6.
7. Copy of letter dated June 26, 2003 from the Sales and Use Tax Division to the Taxpayer's representative, designated Exhibit E-7.
8. XXXXXXXXXXXXX advertisement and coupon package, with examples, mailed to a typical [city in North Carolina], customer, designated Exhibit E-8.
9. Copy of Taxpayer's internal records: Total Charge Worksheets with various dates, designated Exhibit E-9.
10. Copy of sample invoice, Number 5584, dated December 3, 2001 from the Taxpayer to a customer, designated Exhibit E-10.

11. Copy of Taxpayer's internal records: Sales by Item Detail records dated October 2, 2002, designated Exhibit E-11.
12. Copy of Sales and Use Tax Technical Bulletin 24-1 dated June 1, 2002, designated Exhibit E-12.
13. Copy of letter dated October 20, 2003 from the Assistant Secretary of Revenue to the Taxpayer's representative, designated Exhibit E-13.
14. Copy of letter dated December 10, 2003 from the Assistant Secretary of Revenue to the Taxpayer, designated Exhibit E-14.

The following exhibits were submitted by the parties during or after the administrative hearing on January 15, 2004.

15. Brief for Tax Hearing, dated January 15, 2004 from the Sales and Use Tax Division to the Assistant Secretary of Revenue for Administrative Tax Hearings, designated Exhibit E-15.
16. Memorandum dated January 16, 2004 from the Sales and Use Tax Division to the Assistant Secretary of Revenue for Administrative Tax Hearings, designated Exhibit E-16.
17. Copy of letter dated February 26, 2004 from the Sales and Use Tax Division to the Taxpayer's representative dated February 26, 2004, designated Exhibit E-17.
18. Copy of letter dated March 9, 2004 from the Taxpayer to the Sales and Use Tax Division, designated Exhibit E-18.
19. Copy of letter dated March 12, 2004 from the Assistant Secretary of Revenue for Administrative Tax Hearings to the Taxpayer, designated Exhibit E-19.
20. Copy of letter dated April 13, 2004 from the Taxpayer to the Assistant Director of the Sales and Use Tax Division, designated Exhibit E-20.
21. Copy of letter dated April 14, 2004 from the Sales and Use Tax Division to the Revenue Field Audit Supervisor in Raleigh, North Carolina, designated Exhibit E-21.
22. Copy of Memorandum dated April 21, 2004 from the Assistant Director of the Sales and Use Tax Division to the Assistant Secretary of Revenue for Administrative Tax Hearings, designated Exhibit E-22.
23. Copy of E-mail dated May 18, 2004 from the examining auditor to the Sales and Use Tax Division, designated Exhibit E-23.

24. Copy of Memorandum dated May 19, 2004 from the Sales and Use Tax Division to the Assistant Secretary of Revenue for Administrative Tax Hearings, designated Exhibit E-24.

FINDINGS OF FACT

Based on the foregoing evidence of record, the Assistant Secretary of Revenue for Administrative Tax Hearings makes the following findings of fact:

- (1) The Taxpayer is an independent franchisee of [Direct Mail Franchisor], which is headquartered in [out of state]. The company has franchisees around the country that are limited to certain sales territories.
- (2) XXXXXXXXXXXXX is an envelope containing coupons and advertisements from various retailers which is mailed to citizens in the North Raleigh area on a regular basis at no charge.
- (3) The Taxpayer has two separate Divisions: “[ABC]” is a direct mail advertising agency that provides “solo” or individual printing for customers and is considered a retail printing business and “[XYZ]” is an direct mail advertising business that provides group mailings of stuffed envelopes for multiple customers in [a city in North Carolina]. The Taxpayer is liable for sales tax on the individual printing and use tax on the delivered cost of the stuffed envelopes.
- (4) The Taxpayer solicits clients to advertise in the [XYZ] and the clients either supply their own printed advertisements or the advertisement is prepared by the Taxpayer.
- (5) The [Direct Mail Franchisor] headquarters ships the packages of envelopes by truck to a distribution center in [a North Carolina city]. The envelopes are then sorted by postal zip code and delivered to the appropriate post offices to be mailed.
- (6) The additional tax resulted from the Taxpayer’s failure to remit sales tax on single, or solo mailings of printed material, and use tax on group printed advertising matter which they directed to be shipped into the State for ultimate distribution to their clients’ potential customers via the U. S. Postal Service.
- (7) Separately stated postage charges are not subject to sales or use tax prior to January 1, 2002.
- (8) The “true object” of the “solo” printed advertisement sought by the Taxpayer’s clients and placed into the mail on their behalf by the Taxpayer was the printed advertisement sent to potential customers.

- (9) The consideration paid to the [Direct Mail Franchisor] represents a purchase of taxable tangible personal property rather than for some obscure, indefinite rights to “advertising services” or a franchise fee.
- (10) Based on additional information furnished by the Taxpayer, I am directing that the Sales and Use Tax Division make the appropriate adjustment to the proposed assessment. The reduction to the additional tax assessed stems from exempt postage charged on invoices prior to January 1, 2002 as well as invoices from a third party printer in North Carolina which showed that the tax was collected from June 30, 1998 through May 9, 2001.
- (11) The Notice of Proposed assessment was mailed to the Taxpayer on January 3, 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 for Administrative Tax Hearings 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 tangible personal property which can be weighed, measured, felt and touched.
- (3) 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.
- (4) G.S. 105-264 provides that when the Secretary interprets a law by adopting a rule or publishing a bulletin on the law, taxpayers are entitled to rely on the

interpretation. However, G.S. 105-264 only protects the Taxpayer when they have requested advice from the Department on sales or use tax or other tax matters and no such protection exists when the Taxpayer receives erroneous advice from attorneys accountants or any other type of tax advisor that is not an employee of the Department of Revenue. The Department of Revenue is not estopped from assessing sales and use tax against the Taxpayer despite the alleged erroneous advice from an attorney.

- (5) G.S. 105-164.3(4), prior to January 1, 2002, provides that “‘ cost price’ means the actual cost of articles of tangible personal property without any deductions therefrom on account of the cost of materials used, cash discounts, labor or service costs, transportation charges or any expenses whatsoever.” Effective January 1, 2002, “purchase price” under G.S. 105-164.3(33) provides that “The term has the same meaning as the term ‘ sales price’ when applied to an item subject to use tax.”
- (6) The auditors utilized a projection to determine the Taxpayer’s use tax liability on purchases of administrative materials. Pursuant to G.S. 105-241.1(a), the auditors utilized the Taxpayer’s Federal tax return, Form 1120S, and the Taxpayer’s sales summaries in making this use tax projection which was the best information available. In some cases, such as the “solo” printing, the actual invoices were provided as examples.
- (7) The “solo” printing sold by the Taxpayer and the stuffed envelopes purchased from the [Direct Mail Franchisor] are considered taxable tangible personal property.
- (8) The essence of what the [Direct Mail 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.”
- (9) 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).
- (10) 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 [Direct Mail Franchisor], headquartered in [an out-of-state location] which has franchisees around the country that are limited to specific sales territories. The [XYZ] is an envelope containing coupons and

advertisements from various retailers which is mailed to residents in a specific area on a periodic basis at no charge. The Taxpayer solicits clients who either supply their own printed advertisements or have an advertisement prepared by the Taxpayer which is included in the [XYZ] by the franchisor.

The Taxpayer's advertisements are printed and stuffed into envelopes in [an out-of-state area], then sent by truck to a distribution center in [a city in North Carolina]. The [out-of-state area] headquarters bills the Taxpayer for the stuffed envelopes including all charges for postage, shipping and handling. The Sales and Use Tax Division agrees that the Taxpayer, under these circumstances, provides an advertising service and should not charge their clients sales tax for advertising in the [XYZ]. However, it is the Sales Tax Division's position that the Taxpayer is liable for the use tax on the delivered cost of the stuffed envelopes purchased and delivered to the U. S. Post Office in North Carolina for use in performing their advertising services.

The Taxpayer also prints some advertising and mails it for local businesses which is considered by the Sales and Use Tax Division to be a retail sale of taxable tangible personal property. The Taxpayer argues that this is a nontaxable sale of advertising services and that the postage charges for the mailings should not be included as a part of the tax base on which sales tax is computed. The Sales and Use Tax Division's position is that postage charges prior to January 1, 2002 are not subject to tax. However, the charges must be separately identified and not a postage charge for delivery of the printed matter from the out-of-state printer in [an area outside North

Carolina] to the Taxpayer in this case which would become a part of the “sales price” or “purchase price” of the printed matter.

G.S. 105-164.3(18), prior to January 1, 2002, provides that “‘ Use’ means and includes the exercise of any right or power or dominion whatsoever over tangible personal property by a purchaser thereof and includes, but is not limited to, any withdrawal from storage, installation, affixation to real or personal property, exhaustion or consumption of tangible personal property by the owner or purchaser thereof, but shall not include the sale of tangible personal property in the regular course of business.” The 2001 General Assembly amended this definition to add “distribution,” effective January 1, 2002, to the list of activities that constitute “use” for sales and use tax purposes and recodified the statute under G.S. 105-164.3(49). This addition is a change from prior law. The change brings North Carolina law in line with the United States Supreme Court decision in the case of McNamara v. D. H. Holmes Co., Ltd. Under the rewritten definition, use tax is due when an in-state retailer contracts with an out-of-state printer to print catalogues or other material and mail the material directly from the printer’s place of business to the retailer’s customers in North Carolina. Therefore, since January 1, 2002 the postage charges (“distribution”) are subject to sales tax whether or not they are set forth separately. Further, the essence of what the [Direct Mail 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.”

The transactions described in the above paragraph are facilitated by the two separate Divisions of the Taxpayer's business. "[ABC]" which provides the aforementioned "solo" printing and is subject to sales tax and "[XYZ]" which provides the group stuffed envelope mailings which have been subjected to use tax.

The Taxpayer asserts that they relied on the erroneous advice of an attorney for their sales and use tax reporting. Accordingly, the Taxpayer believes that they should not be held accountable for sales taxes on prior sales for which they failed to collect the sales tax or held liable for use tax liabilities for which they failed to accrue and remit the use tax. G.S. 105-264 provides that when the Secretary interprets a law by adopting a rule or publishing a bulletin on the law, taxpayers are entitled to rely on the interpretation. If a taxpayer requests in writing specific advice from the Department and receives erroneous written advice in response, the taxpayer is not liable for an additional assessment of tax attributable to the erroneous advice provided the information furnished to the Department was adequate and accurate. Given this remedy, I must agree with the Sales and Use Tax Division that the Department is not estopped from assessing sales and use tax against the Taxpayer despite the alleged erroneous advice from an attorney.

G.S. 105-164.3(4), prior to January 1, 2002, provides that "' cost price' means the actual cost of articles of tangible personal property without any deductions therefrom on account of the cost of materials used, cash discounts, labor or service costs, transportation charges or any expenses whatsoever." Effective January 1, 2002,

“purchase price” under G.S. 105-164.3(33) provides that “The term has the same meaning as the term ‘ sales price’ when applied to an item subject to use tax.”

The “solo” printing sold by the Taxpayer and the group [XYZ] 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.”

The Department’s auditors utilized the best information available to them. This included the Taxpayer’s Federal Tax return, Form 1120S and their computerized sales summaries of the group [XYZ] mailings of stuffed envelopes. In some cases such as “solo” printing, the actual invoices were provided as examples. In reviewing these, I can make no other conclusion than that the selling parties, the Taxpayer in the “solo” printing and the [out-of-state Direct Mail Franchisor] in the group mailings, sold taxable tangible personal property. Under North Carolina law the “solo” printing is subject to sales and use tax on the delivered “sales price” and the group mailings are subject to use tax on the delivered “purchase price” as defined by statute.

Therefore, with respect to the group mailings, I agree with the Sales and Use Tax Division that the consideration paid by the Taxpayer to the [Direct Mail 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. It is my opinion that the printed matter, specifically stuffed envelopes, are purchased by the Taxpayer in order to fulfill their contractual obligations to their clients. The true object of the transactions are the stuffed envelopes and without their

periodic delivery to the Taxpayer's clients, there would be no business operations for the Taxpayer.

Based on additional information furnished by the Taxpayer subsequent to the tax hearing, I am directing that the Sales and Use Tax Division make the appropriate adjustment to the proposed assessment. The additional information considered included documentation showing the amount of exempt postage charged on invoices prior to January 1, 2002 as well as invoices from a third party printer in North Carolina which showed that the tax was collected from June 30, 1998 through May 9, 2001. As a result, the amount determined to be finally due and payable is set forth below:

	<u>Original Audit</u>	<u>Adjustment</u>	<u>Adjusted Proposed Assessment</u>
Tax:	\$124,417.95	(\$31,510.74)	\$92,907.21
Penalty:	\$ 73,368.15	(\$17,623.83)	\$55,744.32
Interest: (to 7/15/04)	<u>\$ 37,987.98</u>	<u>(\$ 8,667.15)</u>	<u>\$29,320.83</u>
Total: Tax, Penalty & Interest to July 15, 2004	<u>\$235,774.08</u>	<u>(\$57,801.72)</u>	<u>\$177,972.36</u>

Therefore the proposed assessment of tax, penalty and interest as adjusted is deemed correct under the law and the facts and is hereby sustained and declared to be final and immediately due and collectible with interest as allowed by law.

This 30th day of June, 2004.

Eugene J. Cella
Assistant Secretary of Revenue for
Administrative Tax Hearings

