

STATE OF NORTH CAROLINA

BEFORE THE SECRETARY OF REVENUE

COUNTY OF WAKE

OF NORTH CAROLINA

IN THE MATTER OF:

The Proposed Assessment of Sales and Use )  
 Tax for the period January 1, 2000 through )  
 November 30, 2004, by the Secretary of )  
 Revenue of North Carolina )  
 )  
 vs. )  
 )  
 [Taxpayer] )

**FINAL DECISION**  
**Docket No. 2006-154**

This matter was heard by the Assistant Secretary of Administrative Hearings, Eugene J. Cella, upon application for hearing by [the Taxpayer], (Taxpayer) wherein they protested the proposed assessment of tax, penalty and interest for the period January 1, 2000 through November 30, 2004. The hearing was held by the Assistant Secretary pursuant to the provisions of G.S. 105-260.1 and was attended by W. Timothy Holmes, Assistant Director, and Richard C. Stewart, Administration Officer, representing the Sales and Use Tax Division. The Taxpayer was represented by [Attorneys At Law], attorneys for [law firm], [Taxpayer CEO], [Taxpayer's CPA], [Taxpayer's CPA], [Taxpayer's Controller], [paralegal], and [Finance Officer with a health and beauty products manufacturer with whom the Taxpayer contracts].

Pursuant to G.S. 105-241.1, the Department mailed a Notice of Proposed Assessment to the Taxpayer on November 8, 2005 and by letter dated December 5, 2005, the Taxpayer timely requested a hearing before the Secretary of Revenue.

**ISSUE**

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

## EVIDENCE

The following items were introduced into evidence at the hearing:

1. Copy of memorandum dated May 16, 2001 from the Secretary of Revenue to the Assistant Secretary of Administrative Hearings, designated Exhibit E-1.
2. Copy of the Auditor's report Sales and Use Tax dated November 4, 2005 covering the period January 1, 2000 through November 30, 2004, designated Exhibit E-2.
3. Copy of Notice of Sales and Use Tax Assessment dated November 8, 2005, designated Exhibit E-3.
4. Copy of letter dated November 17, 2005 from the Taxpayer's representative to the Sales and Use Tax Division ("Division"), designated Exhibit E-4.
5. Copy of letter dated November 29, 2005, from the Division to the Taxpayer's representative, designated Exhibit E-5.
6. Copy of letter dated December 5, 2005 from the Taxpayer's representative to the Division, designated Exhibit E-6.
7. Copy of letter dated December 20, 2005 from the Division to the Taxpayer's representative, designated Exhibit E-7.
8. Copy of letter dated January 21, 2006 from the Taxpayer's representative to the Division, designated Exhibit E-8, with attached copies of:
  - a. Schedule from Taxpayer Summary of Tax Due, designated Exhibit E-8a, and
  - b. Contract Packing Services Agreement Between [a health and beauty products manufacturer] and [Taxpayer], designated Exhibit 8-b.
9. Copy of letter dated January 27, 2006, from the Division to Taxpayer's representative, designated Exhibit E-9.
10. Copy of redacted Final Decision Docket No. 2003-68, designated Exhibit E-10.
11. Copy of Sales and Use Tax Technical Bulletin 2-1 dated July 1, 2005, designated Exhibit E-11.
12. Copy of Sales and Use Tax Technical Bulletin 3-6 dated July 1, 2005, designated Exhibit E-12.

13. Copy of letter dated May 23, 2006, from the Assistant Secretary of Administrative Hearings to the Taxpayer's representative, designated Exhibit E-13.
14. Copy of letter dated July 12, 2006 from the Taxpayer's representative to the Assistant Secretary of Administrative Hearings, designated Exhibit E-14.
15. Copy of letter dated July 14, 2006 from the Assistant Secretary of Administrative Hearings to the Taxpayer's representative, designated Exhibit E-15.
16. Copy of letter dated September 7, 2006 from the Taxpayer's representative to the Assistant Secretary of Administrative Hearings, designated Exhibit E-16.
17. Copy of letter dated September 20, 2006 from the Assistant Secretary of Administrative Hearings to the Taxpayer's representative, designated Exhibit E-17.
18. Copy of Brief for Tax Hearing prepared by the Division, designated Exhibit E-18.
19. Copy of collection of pictures of [Taxpayer], facility, designated TP-1.
20. Copy of screen prints relating to [a health and beauty products manufacturer's], material requirements and costs reports, designated TP-2.
21. Copy of [a health and beauty products manufacturer] purchase order, designated TP-3.
22. Copy of schedule "[Taxpayer's] Exempt Purchases," designated TP-4.
23. Copy of schedule "[Taxpayer's] Exempt Purchases – Supplies used for packing for transshipment from line to line or manufacturing facility (not received by end user)," designated TP-4A.
24. Copy of schedule "[Taxpayer's] Exempt Purchases – Supplied affixed to packaging received by end user," designated TP-4B.
25. Copy of schedule "[Taxpayer's] Purchases Taxable at 1%," designated TP-5.
26. Copy of schedule "[Taxpayer's] Taxable at General Rate," designated TP-6.
27. Copy of letter dated December 15, 2006, from the Taxpayer's representative to the Assistant Secretary of Administrative Hearings, designated TP-7.
28. Copy of Memorandum dated December 18, 2006 from the Division to the Assistant Secretary of Administrative Hearings, designated E-19.

29. Copy of letter dated December 22, 2006 from the Assistant Secretary of Administrative Hearings to the Division, designated E-20.
30. Copy of Memorandum dated January 2, 2007, from the Division to the Assistant Secretary of Administrative Hearings, designated E-21.
31. Copy of letter dated January 8, 2007 from the Taxpayer's representative to the Assistant Secretary of Administrative Hearings, designated TP-8.

### **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 business providing contract assembly work for a health and beauty products manufacturer.
2. The Taxpayer is a dedicated facility that provides product assembly services for only one manufacturer.
3. The Taxpayer receives individual products from the manufacturer and combines them with other products also provided by the manufacturer for sale as a single item.
4. The Taxpayer assembles the components to form a finished product.
5. After the Taxpayer combines the items, the products are in most cases returned to the manufacturer. In some isolated cases, the combined products are sent to a distribution center.
6. About 60% of the products made by the manufacturer are sold in the form of a gift set containing the combined products. About 40% of the manufacturer's products are sold as individual items.
7. The manufacturer classifies the individual products received by the Taxpayer, which are combined with other manufactured products and sold as a unit, to be work in progress on their organizational charts.
8. After the products are combined and packaged by the Taxpayer, they are returned to the manufacturer and then sent to the manufacturer's distribution and logistics department.
9. The Taxpayer does not take title or ownership of the products it combines and packages for the manufacturer.

10. The pallets of product sent from the Taxpayer back to the manufacturer are usually disassembled and placed on other pallets for shipment to the manufacturer's distributors.
11. The Notice of Sales and Use Tax Assessment was mailed to the Taxpayer on November 8, 2005.
12. The Taxpayer objected to the assessment by letter dated November 14, 2005 and made a timely request for hearing.

### **CONCLUSIONS OF LAW**

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

1. Simply packaging or repackaging does not constitute manufacturing.
2. The assembly and service the Taxpayer provides to the manufacturer constitutes an integral part of the manufacturing process.
3. The Taxpayer is operating as a contract manufacturer on behalf of the manufacturer.
4. Sales of equipment and machinery used by the Taxpayer in the assembling of the health and beauty products are subject to the 1% rate of State tax with a maximum tax of \$80.00 per article.
5. Sales of shipping and packaging materials purchased by the Taxpayer that become a part of the packaging that are received by the end user as a part of the product purchased are exempt from North Carolina sales and use tax.
6. Sales of shipping and packaging materials purchased by the Taxpayer that are used for packing and transshipment from the Taxpayer to the manufacturer are subject to the 1% rate of State sales or use tax.
7. Sales of machinery and equipment purchased by the Taxpayer that are not used directly in the assembly service the Taxpayer provides to the manufacturer are subject to the combined general rate of State and local sales and use taxes.
8. Sales of materials, supplies and other tangible personal property not used directly in the assembly service the Taxpayer provides to the manufacturer are subject to the combined general rate of State and local sales and use taxes.
9. For the period covered by the assessment, G.S. 105-164.6, G.S. 105-468, G.S. 105-483, G.S. 105-498 and G.S. 105-517 impose the applicable State and local

use tax on the purchase of tangible personal property for storage, use or consumption in this State.

10. For the period covered by the assessment, G.S. 105-164.4A (2) levies a tax 1% with a maximum tax of \$80.00 per article on sales to manufacturers of manufacturing equipment and accessories to manufacturing equipment.
11. The Notice of Proposed assessment was issued to the Taxpayer on November 8, 2005, pursuant to G.S. 105-241.1.
12. The assessment of State and local sales and use taxes, along with applicable penalties and interest, shall be amended.

### **DECISION**

Based on the findings of fact and conclusions of law, I find that the contract assembly services performed by the Taxpayer on behalf of the manufacturer are an integral part of the manufacturing process and the Taxpayer is acting in the capacity of a contract manufacturer. Therefore, the proposed assessment of tax, penalty and interest for the audit period shall be amended as set forth herein. 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.

This 9th day of April 2007.

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Eugene J. Cella  
Assistant Secretary of Administrative Hearing