JURISDICTION: **OKLAHOMA TAX COMMISSION - DECISION**
CITE: **2001-04-12-003 / NOT PRECEDENTIAL**
ID: **P9600544**
DATE: **04-12-01**
DISPOSITION: **DENIED**
TAX TYPE: **SALES / USE**
APPEAL: **OK SUP CT 96,267**
REVERSED IN PART / AFFIRMED IN PART

FINDINGS OF FACT AND CONCLUSIONS OF LAW

1. The Audit division of the Oklahoma Tax Commission, "Division" hereafter, conducted an audit of the books and records of PROTESTANT CORPORATION for the audit period January 1, 1993, through December 31, 1995. On October 22, 1996, the Division issued proposed assessments of sales and use tax to PROTESTANT for the audit period.

2. PROTESTANT timely filed a protest to the proposed assessments by letter of November 18, 1996. Thereafter, PROTESTANT submitted additional information which the Division used to revise its proposed assessments for sales and use tax. This protest concerns sales and use tax assessed upon three main subjects which are: (1) rock quarries, (2) sand plants, and (3) agriculture exemption. The Substitute Exhibit 54 filed herein on April 20, 1998, sets out the final protested amount of sales and use taxes assessed for each subject as follows:

Rock quarry total protested tax	$ 8,447.00
Sand plant total protested tax	$11,154.00
Agriculture exemptions total protested tax	$ 15,451.00
TOTAL	$ 35,052.00

Additional amounts for interest and penalty are applicable to these totals but were not calculated for the purposes of this hearing in Substitute Exhibit 54.

3. On March 14, 1997, PROTESTANT filed a claim for refund of sales taxes paid to the Tax Commission on its rock quarry and sand plant operations for the years 1993, 1994, 1995 and 1996 in the amount of $784,298. The amount of the refund claim was later amended and is set out in Substitute Exhibit 55, filed herein on April 20, 1998, in the amount of $814,613.00. The Division reviewed PROTESTANT's claim for refund and granted a refund on certain portions of the rock quarry operations which qualified for the manufacturing exemption in the amount of $539,930.00. The Division denied the balance of the claim for refund. Substitute Exhibit 55 sets out the final protested amount of sales tax for which a refund was denied on the following subjects:

Rock quarry total sales tax refund protested	$155,988.00
Sand plant total sales tax refund protested	$118,695.00
TOTAL	$274,683.00

4. PROTESTANT is an Oklahoma corporation with its principal place of business and corporate headquarters located in Oklahoma City, Oklahoma. PROTESTANT operates ready-mix concrete plants to supply building contractors with concrete products and PROTESTANT also operates sand production plants and rock quarries located throughout the State of Oklahoma which provide products to the construction industry. PROTESTANT has been issued a Manufacturer's Limited Exemption Certificate, or MLEC, for certain parts of its rock quarries beginning with the conveyance of the rock to the first rock crusher. The MLEC provides an exemption from sales tax to PROTESTANT on its purchases of machinery and equipment used in a manufacturing operation. The manufacturing exemption, according to the Division, did not apply to PROTESTANT's sand plants nor to PROTESTANT's operations in the rock quarry prior to conveyance of the rock to the first crusher.

A. Stone Crushing

5. PROTESTANT operates several stone crushing operations in the State of Oklahoma where it manufactures crushed stone for a number of construction uses including concrete and erosion control. While much of the finished product is used in Oklahoma, some of the stone is shipped to Texas and Kansas.

6. PROTESTANT produces crushed stone using the following process.

a. Heavy equipment is used to remove the overburden from above a stone formation. The overburden is a layer of the earth that includes dirt, clay, vegetation, and other nonusable materials. This is an essential step in the stone crushing process, because overburden contaminates the end product and clogs the machinery used in the later stages of the stone crushing process.

b. Equipment strategically drills holes in the exposed rock face where explosives are placed. The explosive's engineer uses complex formulas to calculate the placement of the drill holes, the depth of the drill holes, and the amount of explosives to be placed in each drill hole. Fuel oil and fertilizer are mixed on site and placed in each hole. Blasting caps and delay devices are used to maximize the results of the explosion. The detonation of the explosives fractures the stone formation resulting in stone that is ready for crushing.

c. Much of the "shot-down rock" is in the form of riprap or large rock pieces. Riprap is used primarily for erosion control along the shore of rivers and lakes and alongside highways. The shot-down riprap must only be sorted by size to be marketable. The pieces require no further fragmentation.

d. Most of the remaining shot-down rock is ready for further manufacturing. However, some rock is simply too large to fit into the crushing machinery. This rock must be broken by a process called "secondary breakage." Secondary breakage is the application of mechanical force to the rock by using a drop ball or a hydraulic hammer.

e. The resulting shot-down and fragmented rock is placed on a feeder to the mobile "primary crusher." Not all shot-down rock passes through the primary crusher. Only pieces 7 inches in diameter or larger require primary breakage. Rock that does not require breakage falls onto a lower conveyor for further manufacturing by rushing, screening, and conveying. Rock that is larger than 7 inches enters the gyratory primary crusher where it is broken into smaller pieces and placed on the same conveyor as the rock that is less than 7 inches.

f. At this stage in the process, the stone has been fractured through three different methods: explosives, secondary breakage, and primary crushing. All of the stone on the conveyor is now less than 7 inches in diameter. A continuous series of conveyors takes the stone to the main processing plant.

g. At the main processing plant, the stone is further processed by undergoing "secondary/tertiary crushing." The crushed stone is sorted by size and placed in overhead bins for temporary storage. The stored stone can be sold directly from the bin or be blended with the stone of any other bin for any customer's special needs. Trucks are used to empty the full bins and to transfer the stone to the stockpiles.

7. The crushed stone has different qualities from the rock as it sits in its formation on the face of the mountain.

B. Sand Plants

8. Taxpayer operates four sand plants in Oklahoma. The plants produce uniformly blended sand, which is primarily used in making concrete.

9. Taxpayer has requested the Division to exempt the sand plants as a manufacturing facility. The Division has consistently taken the position that sand production is not manufacturing.

10. Blended sand is produced by the following process:

a. Heavy equipment is used to remove the overburden from above a sand deposit. The overburden is a layer of the earth that includes dirt, clay, vegetation, and other non-usable materials. This is an essential step in the sand production process because the deleterious materials in the overburden clog the screens and the resulting sand will not meet the specifications required.

b. Once the overburden is removed, water fills the newly created lake and a dredge is placed in the water to create and extract a sand-water slurry. Not all of the sand suspended in the slurry is marketable--58 percent of the sand in the slurry is returned to the pit. The slurry is then pumped into a classifying tank where it is sorted and blended into a uniform and marketable product that meets rigorous industry standards.

c. The sand-water slurry is first screened as it enters the classifying tank. As the mixture enters the tank, particles fall out into different stations according to particle size. A computer senses the amount of each different particle size in the stations and releases a measured amount of the different particles into a blending cell.

d. The blended sand then passes through a blade mill. The blade mill strikes the particles and removes any clay deposits that will weaken a subsequent concrete mixture. The mill also agitates the particles causing them to strike each other. This action also works to remove clay deposits and improves the quality of the sand.

e. The resulting blend is unlike its natural counterpart. The most important difference is the resulting uniformity of the blended sand. While the percentage of each different particle size in the deposit varies greatly as the slurry is created, computer blending techniques compensates for the differences and produces a uniform sand suitable for concrete used in modern construction projects. Sand in its natural state cannot meet the needs of modern construction.

11. PROTESTANT's rock quarry and sand production plants have been significantly aided by advancements in automated production technologies applied to this industry within the last 40 years. PROTESTANT's operations have become more efficient regarding manpower and production costs while producing an improved product with enhanced performance to satisfy the increasing demands for its building products.

D. (Sic) Agricultural Sales

12. PROTESTANT also sold its product exempt from sales tax to purchasers who held an agricultural exemption permit. The Division audited PROTESTANT's sales to agricultural exemption permit holders and determined that the sales were not eligible for the agricultural exemption because the product was not used for an exempt agricultural purpose.

ISSUES

1. At what point in the production process does crushed stone manufacturing begin?

2. Is the sand production plant a manufacturing facility?

3. Whether PROTESTANT is entitled to claim exemption from sales tax on products sold to holders of agricultural exemption permits without verifying the use of the product for agriculture.

CONCLUSIONS OF LAW

1. The Oklahoma Tax Commission has jurisdiction of this protest, 68 O.S. Sections 207, 221.

2. A proposed assessment is presumed correct and the taxpayer bears the burden of showing that it is incorrect, and in what respect. *Enterprise Management Consultants, Inc. v. Oklahoma Tax Commission*, 768 P.2d 359 (Okl. 1988). Failure to provide evidence which is sufficient to show an adjustment to the proposed assessment is warranted will result in the denial of the protest. *Continental Oil Company v. Oklahoma Tax Commission,* 570 P.2d 315 (Okl. 1977). The burden of proving a sale is not a taxable sale is on the person who made the sale, 68 O.S.1991, Section 1365(C).

3. The standard burden of proof in administrative proceedings is "preponderance of evidence." See Oklahoma Tax Commission Order No. 91-10-17-61. *Black's Law Dictionary,* 1064 (5th ed. 1979) defines "preponderance of evidence" as "[E]vidence which is of greater weight or more convincing than the evidence which is offered in opposition to it; that is, evidence which as a whole shows that the fact sought to be proved is more probable than not." Id. It is also defined to mean "evidence which is more credible and convincing to the mind . . . [T]hat which best accords with reason and probability." Id.

A. Crushed Stone Manufacturing

4. In 1947, Oklahoma enacted a sales tax exemption for manufacturing plants. In order to implement this exemption, and pursuant to its rule making authority (See 68 O.S. Section 203), the Oklahoma Tax Commission issued Order No. 20641 on July 26, 1947, in which it held that sand companies, rock crushers and quarries were not establishments primarily engaged in manufacturing or generally recognized as such.

The Oklahoma Supreme Court reviewed this rule in Tulsa *Machinery Co. v. Oklahoma Tax Commission,* 253 P.2d 1067, 1953 OK 52, in which a company that produced crushed stone for use in the construction industry sought the sales tax manufacturing exemption for the machinery used in that process similar to the case at bar. The Supreme Court relied on its earlier case of *Cains Coffee Co. v. City of Muskogee,* 44 P.2d 50, 1935 OK 450, for the definition of manufacturing which held:

> As used in the statute, the word "manufacture" is not to be given its technical meaning. The Century Dictionary defines it as "the production of articles for use from raw or prepared materials by giving these materials new forms, qualities, properties, or combinations, whether by hand labor or machine."
>
> Whenever labor is bestowed upon an article which results in its assuming a new form, possessing new qualities or new combinations, the process of manufacturing has taken place whether the thing produced be a small article of commerce or a structure, such as a house, road, or bridge.

The Court concluded in *Cains* that the process of preparing coffee, tea and spices for human consumption was manufacturing. In *Tulsa Machinery,* the Supreme Court reasoned that if the activities in which the Cains Coffee Company in that case was engaged constitute manufacturing then the activities in which the crushed rock companies were engaged in changing the form of rocks by placing them through various crushers, likewise constitute manufacturing. However, the Supreme Court specifically identified when manufacturing occurred as follows:

> Before the exemption may be claimed it must be shown that the machinery and equipment sold by it to these companies, was by then "incorporated into and directly used in the manufacturing of property subject to taxation" under the Sales Tax Act. Although the above companies were engaged in manufacturing, process of manufacturing did not take place or commence until the rock was conveyed to and placed in the first crusher.

5. The next case concerning rock crushing manufacturers is *McKee Products v. Oklahoma Tax Commission,* 805 P.2d 110, 1989 OK CIV APP 83, which involved the application of the manufacturing exemption to equipment used to load, transport and store crushed rock after the rock had been fully processed. Citing *Oklahoma Tax Commission v. Oklahoma Coca-Cola Bottling Co,* 494 P.2d 312, 1972 OK 20, a case concerning whether mechanical bottle washers were "an integral part of the manufacturing process," in which the Supreme Court noted that the final product was the aggregate result of all the machines in an automated plant, the Court of Appeals in *McKee Products* found that the machines used to load, transport and store crushed rock were used in manufacturing and entitled to the sales tax exemption because
". . . machines and equipment used at the end of the manufacturing process for packaging and delivery are necessary for the sale and distribution of the product."

6. After the Court of Appeals decision in *McKee,* the Oklahoma sales and use tax manufacturing exemption has undergone drastic change within the last decade. Before the audit period in this case, the manufacturing exemption at 68 O.S. 1991 Section 1359(A) provided:

> There are hereby specifically exempted from the tax levied by this article:
>
> Goods, wares, merchandise, and property purchased for the purpose of being used or consumed in the process of manufacturing, compounding, processing, assembling, or preparing for sale a finished article and such goods, wares, merchandise, or property become integral parts of the manufactured, compounded, processed, assembled, or prepared products or are consumed in the process of manufacturing, compounding, processing, assembling, or preparing products for resale. The term manufacturing plants shall mean those establishments primarily engaged in manufacturing or processing operations, and generally recognized as such.

The same exemption was provided for use tax pursuant to 68 O.S. 1991 Section 1404(d). This exemption was strictly construed by the Tax Commission against the exemption, *McDonald's Corp. v. Oklahoma Tax Commission,* 563 P.2d 635, 1977 OK 74. The Tax Commission's strict construction of the exemption was tested in the case of *Schulte Oil Co. v. Oklahoma Tax Commission,* 882 P.2d 65, 1994 OK 103. The *Schulte* case concerned a company that remanufactured used oil field pipe. The company would acquire used oil field pipe that was damaged or unusable. THE SCHULTE APPELLANT would then process this unusable pipe in an extensive

remanufacturing system that produced a usable product. THE SCHULTE APPELLANT remanufactured pipe that it had purchased for its own account as well as pipe owned by other companies. The Commission's conclusion that THE SCHULTE APPELLANT was not "primarily engaged in manufacturing" and therefore not entitled to the manufacturing exemption, was reversed by the Supreme Court which held:

> The ultimate purpose of the manufacturer's exemption is to enhance this state's competitive position in inducing industries to locate and expand in Oklahoma. The trend in manufacturing is toward the use of recyclable materials in manufactured goods. The legislature will not be perceived to have intended the exemption to discriminate against those businesses which produce saleable goods from recycled materials by placing them in a less favorable position than those which use new materials. In conformity with the Legislature's apparent objective that of encouraging the development of industry and in the absence of specific provisions for dealing with the remanufacturing of used, recyclable goods, we hold that the Section 1352(H) definition of "manufacturing" includes both (a) the production of new and raw material and (b) the "remanufacturing" of used and commercially valueless material by the application of machinery, labor and skill which transforms it into a marketable commodity.

The Supreme Court further held that a practical construction of Section 1359 requires that machinery which is synchronized into the manufacturing operation in a manner that makes it necessary to the production of the finished product is "directly used in" the manufacturing process and qualifies for the exemption.

7. After the *Schulte* decision, the State legislature amended Section 1359 to provide the exemption in a broader scope. The manufacturing exemption now states at 68 O.S. Supp. 1999 Section 1359(1) as follows:

> There are hereby specifically exempted from the tax levied by Section 1350 et seq. of this title:
>
> a. Sales of goods, wares, merchandise, tangible personal property, machinery and equipment to a manufacturer for use in a manufacturing operation.

The sales tax code defines "manufacturing" and "manufacturing operation" at 68 O.S. Supp. 1999 Section 1352(9) and (10) as follows:

> "Manufacturing" means and includes the activity of converting or conditioning tangible personal property by changing the form, composition, or quality of character of some existing material or materials, by procedures commonly regarded as manufacturing, compounding, processing or assembling, into a material or materials with a different form or use. "Manufacturing" does not

> include extractive industrial activities such as mining, quarrying, logging, and drilling for oil, gas and water, but may include processes subsequent to extraction if such processes result in a change of the form or use of the material extracted.
>
> "Manufacturing operation" means the designing, manufacturing, compounding, processing, assembling, warehousing, or preparing of articles for sale as tangible personal property. A manufacturing operation begins at the point where the materials enter the manufacturing site and ends at the point where a finished product leaves the manufacturing site. "Manufacturing operation" does not include administration, sales, distribution, transportation, site construction, or site maintenance.

This definition specifically states that manufacturing does not include mining or quarrying although processes subsequent to extraction are included in manufacturing. This definition precludes PROTESTANT's claim to extend the manufacturing exemption beyond the *Tulsa Machinery* case to include the process of removing the overburden from the rock formation and the "drilling and blasting" stage of quarrying the rock before it is transported to the first crusher.

8. The Supreme Court in *Tulsa Machinery* and the Court of Appeals in *McKee Products* considered operations similar to PROTESTANT's operation and declined to apply the manufacturing sales tax exemption to the drilling and blasting stage. Although PROTESTANT argues that its processes in the drilling and blasting stage are more technologically advanced than the processes reviewed in earlier cases, PROTESTANT has not demonstrated how its process qualifies for the manufacturing exemption, especially in the light of recent cases which refused to extend the tax exemption to those processes. The Tax Commission ruled on this issue in Order No. 92-08-04-029 (Affirmed Oklahoma Court of Appeals, Feb. 2, 1994, Case No. 80,242) in which the Commission held:

> The fact that various rock sizes resulted from application of labor (drilling and blasting) to the limestone ledge, is in and of itself not determinative that the various rock sizes, which resulted from the drilling and blasting stage, are marketable. The quarrying of limestone ledge is generally understood to be mining. Although the quarrying changed the form of the rock, the change was such only so far as its severance from the quarry was concerned. In no sense can it be regarded as the manufacture of property.

These prior applicable decisions have set the precedent which must be applied in this case which separates PROTESTANT's nonexempt rock quarrying operation from the exempt rock crushing operation. The State legislature has provided a tax exemption for the mining of coal at Section 1359(13), however, the exemption does not extend to encompass PROTESTANT's operations. Furthermore, the judicial construction of a statute and longstanding acquiescence therein serves to give such judicial construction the effect of legislation. The interpretation of a statute by the highest courts of a state by which the statute was enacted is generally regarded as an integral part of the statute, *Arkansas Louisiana Gas v. Travis,* 682 P.2d 225, 1984 OK 33. Although the *Schulte* decision expanded the definition of manufacturing previously applied by the Tax Commission, *Schulte* did not overrule *Tulsa Machinery* or *McKee* Products which are controlling precedent in this case and preclude the extension of the manufacturing exemption to the mining or quarrying of rock which occurs previous to the manufacturing operation for the production of crushed rock.

B. Production of Sand

9. The facts adduced at hearing demonstrate that PROTESTANT is engaged in the business of extracting sand from the earth at its sand plants by means of a mechanical process. The Oklahoma Tax Commission has never considered sand production to be manufacturing from its earliest rule on the subject in Commission Order 20641, July 26, 1947. The Oklahoma Supreme Court has also concluded that production of sand is not manufacturing in *Curry Materials Co. v. Oklahoma Tax Commission,* 319 P.2d 292, 1957 Ok. 311. The Supreme Court found in *Curry Materials* that the extraction of sand from the earth did not change the form of the material but only its location. PROTESTANT argues that its production techniques are more advanced than those reviewed by the Court in *Curry Materials* and produce a cleaner, more uniform and higher quality sand and that its processes employ more advanced automated equipment. However, the *Curry Materials* opinion has not been overruled and still stands for the ruling that:

> Washing and scouring wool does not make the resulting wool a manufacture of wool. Cleaning and ginning cotton does not make the resulting cotton a manufacture of cotton.

10. The *Curry Materials* case is controlling authority in this case which prevents the application of the Section 1359 manufacturing exemption to the PROTESTANT sand production plants. The *Schulte* decision did not reach the issue presented here. Further, the rule that exemption statutes are to be strictly construed against exemptions remains extant, *Bert Smith Road Machinery Co. v. Oklahoma Tax Commission,* 563 P.2d 641, 1977 OK 75. It is not within the jurisdiction of the Tax Commission to legislate new or expanded exemptions from tax or to determine Oklahoma tax policy in this regard. The production of sand does not come within the definition of manufacturing at Section 1352(9) and does not qualify for the Section 1359 manufacturing exemption.

C. Agricultural Exemption

11. Evidence presented at the hearing indicates that PROTESTANT sold products to certain purchasers exempt from sales tax pursuant to the agriculture exemption at 68 O.S. Section 1358. The Division reviewed these sales and determined that the exemption claimed by PROTESTANT did not apply. The Division then assessed additional sales taxes on these items. OAC 710:65-7-6(b) provides that a vendor will be relieved of any liability for the tax if the vendor, in good faith, timely accepts from a consumer, properly completed documentation certified by the Oklahoma Tax Commission that such consumer is exempt from the taxes levied by the Oklahoma Sales Tax Code. The minimum documentation requirements to establish the agricultural exemption are set out in OAC 710:65-7-6(d)(4) as follows:

> **Sales for agricultural purposes.** In the case of a claimed agricultural exemption, the vendor must obtain the items of information set out in this paragraph:
>
> 1. A copy of the agricultural exemption permit card;
>
> 2. A statement that the articles purchases will be used in agricultural production.
>
> 3. Signature of the permit holder or a person authorized to legally bind the permit holder; and
>
> 4. In the circumstances defined in (a) and (b) of this subparagraph, certification on the face of the invoice or sales ticket is required;
>
> (a) From any person purchasing feed for horses, mules, or draft animals used directly in the production and marketing of agricultural products; or
>
> (b) From any person who is making purchases of materials, supplies, or equipment to be used in the construction of livestock facilities, including facilities for the production and storage of feed, pursuant to a contract with an agricultural permit holder. [See 68 O.S. Supp. 1995, Section 1358(8) and 710:65-13-17..

12. In its protest to the assessment of sales tax on the agricultural transactions, PROTESTANT questions whether the vendor has the duty to verify the end use of a product sold to an individual possessing an agricultural exemption certificate. The controlling case law suggests that the vendor is obligated to fulfill that duty. The burden of proving a sale was not taxable is on the vendor. If a sale is made to an agricultural purchaser, the purchaser must supply the vendor with proof of exemption. The vendor's failure to fulfill this record keeping obligation will subject the vendor to assessment of sales taxes due on those transactions, *Dunn v. Oklahoma Tax Commission*, 862 P.2d 1285, 1993 OK CIV APP 105.

13. PROTESTANT did not present any evidence or testimony at hearing which could prove that any of the agricultural transactions were exempt, nor any form of proof that PROTESTANT had complied with the documentation requirements of OAC 710:65-7-6. On this issue, PROTESTANT failed to carry its burden of proving facts sufficient to show in what respect the action or proposed action of the Tax Commission is incorrect as required by OAC 710:1-5-47. The proposed assessment is presumed to be correct.

14. PROTESTANT's protest to the proposed assessment should be denied.

DISPOSITION

It is the DETERMINATION of the OKLAHOMA TAX COMMISSION, based upon the specific facts and circumstances of this case, that the sales tax and use tax protest of PROTESTANT and OFFICERS of PROTESTANT, AND as individuals be denied.

OKLAHOMA TAX COMMISSION

CAVEAT: This decision was **NOT** deemed precedential by the Commission. This means that the legal conclusions are not generally applicable or are limited in time and/or effect. Non-precedential decisions are not considered binding upon the Commission. Thus, similar issues may be determined on a case-by-case basis.