

JURISDICTION: OKLAHOMA TAX COMMISSION
CITE: 2011-04-19-19 / NON-PRECEDENTIAL
ID: P-09-221-K
DATE: APRIL 19, 2011
DISPOSITION: DENIED
TAX TYPE: SALES
APPEAL: NO APPEAL TAKEN

FINDINGS OF FACT AND CONCLUSIONS OF LAW

Protestant, COMPANY is represented by CPA, CPA. The Compliance Division of the Oklahoma Tax Commission ("Division") formerly represented by OTC ATTORNEY 1, Assistant General Counsel, Office of the General Counsel, Oklahoma Tax Commission is represented by OTC ATTORNEY 2, Assistant General Counsel, Office of the General Counsel, Oklahoma Tax Commission.

STATEMENT OF THE CASE

Upon audit of Protestant's books and records, the Division by letter dated July 17, 2009, issued a proposed use tax assessment against Protestant for the period inclusive of the months of June, 2006 through February, 2009. Protestant timely protested the proposed assessment by letter dated September 14, 2009. Protestant did not request a hearing in the letter of protest.

On or about July 1, 2009, Protestant filed an *Oklahoma Business Registration Application for Manufacturers* ("Application") in which it sought a manufacturer sales tax exemption permit. As the result of the answers provided on the *Application*, the Division by letter dated June 23, 2009¹, denied Protestant's *Application*. Protestant timely protested the denial of the *Application* by letter dated December 21, 2009.

The protest to the proposed use tax assessment was forwarded to the Administrative Law Judges' Office on November 20, 2009. The protest to the *Application* denial was forwarded to this Office on January 5, 2010.

A Pre-hearing conference was scheduled for each protest for January 12, 2010, by *Prehearing Conference Notices* issued December 16, 2009 and January 5, 2010, respectively.² A *Report in Lieu (of Pre-hearing Conference) and Request to Join Cases* was filed January 11, 2010, advising that the parties were jointly requesting a continuance to exchange discovery and that the "cases be joined for the sole purpose of convenience of time and place" and specifying that "any conferences or hearing should be considered concurrently, but the parties briefs, memoranda and ALJ decisions should be considered separately". By *Order* issued January 12, 2010, the parties' requests were granted and they were directed to file a status report on or before February 12, 2010.

¹ The date on the letter is erroneous. The letter was generated and issued on or about July 15, 2009.

² OAC, 710:1-5-28(a).

Status Reports requesting continuances to complete the exchange of information pursuant to informal discovery were filed. By *Status Report* filed July 2, 2010, the parties jointly advised:

Although the parties anticipate that the use tax issue under P-09-194-K may be settled on or before July 9, 2010, the parties have not been able to settle the issue concerning the Division's denial to Protestant's request for a manufacturer exemption permit under P-09-221-K. Protestant desires to have this issue decided on the parties [sic] briefs. The Division has no objection to Protestant's request. The parties stand prepared to submit joint stipulations and briefs at the direction of the court.

By *Scheduling Order* issued July 21, 2010, the procedure was set forth for the submission of these cases for decision.³ By *Status Report* filed July 21, 2010, the Division advised that Joint Stipulations to the facts and issues had been forwarded to Protestant's representative for his consideration and further action.

A *Verified Motion for Summary Disposition* ("*Motion*") was filed by the Division on September 24, 2010. Exhibits A through H were attached to the *Motion*. By letter dated September 29, 2010, Protestant was notified that a response to the *Motion* could be filed on or before November 1, 2010, at which time the *Motion* would be submitted for ruling. The *Brief of the Protestant* ("*Protestant's Brief*") was filed November 1, 2010. Exhibits 1 through 6 were attached thereto. In *Protestant's Brief*, Protestant requested that the use tax protest be stayed pending a decision on the protest to the *Application* denial. On November 4, 2010, the *Motion* was submitted for ruling.⁴

By *Order Reopening Records* issued December 8, 2010, the Court's ruling on the *Motion* was stayed and the record reopened for the submission by the Division of Exhibit I referenced in the *Motion*. Exhibit I was submitted on December 8, 2010. By *Order* issued January 21, 2011, the *Motion* was granted. Upon further review of the record in each case, the undersigned finds that the use tax protest should be stayed pending the decision on the protest to the *Application* denial. Accordingly, the record in Case No. P-09-221-K is closed and the protest to the *Application* denial is submitted for decision on the *Motion*.⁵

FINDINGS OF FACT

Upon review of the file and records, including the *Motion*, *Protestant's Brief* and exhibits attached to each pleading, the undersigned finds:

1. Protestant stipulates that the Statement of Material Facts in the *Motion* is substantially accurate. *Protestant's Brief*, page 1.

³ OAC, 710:1-5-38(a).

⁴ OAC, 710:1-5-38(b).

⁵ OAC, 710:1-5-38(b)(6).

2. The facts material to the disposition of the protest to the *Application* denial are not in dispute and the issue is one of law.

3. The material facts as set out in the *Motion*, STATEMENT OF MATERIAL FACTS, are:

1. Protestant has been in the embroidery business since 2002 and is located at ADDRESS, incorporated under federal identification number ##### and operating under sales tax permit number ### and use tax permit number #####. Protestant's Business Registration application listed PRESIDENT as president and sole officer of the corporation. (Exhibit "A")

2. On or about February 27, 2009, the Division began an audit of the corporation and discovered that Protestant purchased items out of state on which no tax was paid.⁶

3. Using a sampling method for the months of December, 2006; June, 2007; and September, 2008, and projecting the results over the period covering June 1, 2006 through February 28, 2009, and adding to that figure the one-time out-of-state purchases that Protestant made, the Division determined that Protestant owed the State use tax in the principal tax amount of \$8,989.40.⁷ (Exhibit "B")

4. On or about July 17, 2009, the Division assessed Protestant for use tax for the period covering June 1, 2006 through February 28, 2009, in the amount of \$12, 850.70, inclusive of penalty and interest through July 31, 2009. (Exhibit "C")

5. On September 14, 2009, Protestant filed a timely letter of protest signed by President PRESIDENT, who claimed Protestant is exempt from taxation as a manufacturer. (Exhibit "D")

6. On or about July 1, 2009, Protestant's manager, MANAGER ("MANAGER") signed and filed an application for a manufacturer's sales tax exemption permit ("MSEP"). (Exhibit "E")

⁶ An Audit Methodology Agreement consenting to the use of an error rate projection method for determining the amount of sales and use taxes excepting asset items was executed by the parties. Official notice of the Agreement is taken. *OAC*, 710:1-5-36.

⁷ The detailed review of the months of December, 2006; June, 2007; and September, 2008; included those items purchased out-of-state for use in Protestant's business that were booked and/or paid during those months. Protestant's average monthly total expenses as shown on its income statements for the years of 2006, 2007 and 2008 was used as the basis of the projection made from the items purchased out-of-state for use in Protestant's business. The actual amount of the out-of-state purchases booked and/or paid during the audited months were included as the audited amount for those months as opposed to the audited amount determined by the projection. The audit also included two (2) capital asset items purchased by Protestant from out-of-state during the audit period that were separately scheduled and subjected to use tax. Field Audit Write Up and audit work papers (Exhibit B) included in the file of the Office of the Administrative Law Judges and to which official notice is taken. *OAC*, 710:1-5-36.

7. In the application form, MANAGER stated that the company manufactures shirts, jackets, headwear, lab coats, seat covers, towels and vinyl tops and listed the company's NAICS classification number as 315211. (Exhibit "E" at page 3, paragraph 22 [sic and 23])

8. NAICS classification number 315211 refers to "contractors primarily engaged in (1) cutting materials owned by others for men's and boys' apparel and/or (2) sewing materials owned by others for men's and boys' apparel. (Exhibit "F")

9. MANAGER described Protestants' [sic] manufacturing process as "Receive garments & other goods/create designs to alter goods. Embroider designs on goods using various equipment. Ship finished products to customers". He claimed that 95% of the company's products are "one of a kind [sic]; the remaining 5% are "available to all customers", 94% of whom are "Vendors/Retailers." (See Exhibit "E", page 3, paragraphs 24, 25, and 29)

10. Protestant does not maintain an inventory of raw material or finished goods; and asserts that its entire production process is based on each customer's specifications." (See Exhibit "E", page 3, paragraphs 27, [sic] 28)

11. Following its review of Protestant's application for a MSEP, the Division sent Protestant a letter denying its request for the reason that "[S]ervice and repair operations are not commonly regarded as manufacturing processes * * * per O.S. Supp. 2007 §1359". The Division did however, issue Protestant a sales tax permit. (Exhibit "G")⁸

12. Protestant filed a letter protesting the Division's denial. (Exhibit "H")

13. On July 15, 2010, the Division conducted an on-site inspection of Protestant's business and confirmed that Protestant does not qualify for an MSEP. (Exhibit "I").

ISSUE

The issue presented for decision is whether Protestant's embroidery operations are commonly regarded by the average person as manufacturing.

Protestant contends that embroidering a cap, shirt or other existing material with a unique and non-interchangeable design through sophisticated, expensive machinery and equipment changes the form, composition and quality of character of the materials, and by definition constitutes

⁸ Footnote 1 original to the Statement of Material Facts, *Motion* provides "[T]he Division's letter is mistakenly dated June 23, 2009 as supported by the Division's affidavit attached to and made part of the Division's Exhibit G."

manufacturing. In support of this contention, Protestant argues that neither the statutes nor case law prohibits the provision of labor as the predominant activity or source of revenue of a manufacturer, and that neither the statutes nor case law requires the transfer of title to or ownership of the converted or conditioned property by the manufacturer.

The Division contends that embroidering designs on articles of clothing or other material does not change the form, composition or quality of character of the existing material, but rather merely adds a superficial or cosmetic change to an already manufactured product, citing *Kimberton Company v. Commonwealth of Pennsylvania*, 520 A.2d 904 (1987). The Division further cites *OAC*, 710:65-19-60, which addresses “made-to-order and custom sales”, and specifically disallows a tax exemption on the purchase of “equipment, tools and supplies directly used or consumed in the production of such articles and not becoming a part thereof”.

CONCLUSIONS OF LAW

1. Jurisdiction of the parties and subject matter of this proceeding is vested in the Oklahoma Tax Commission. 68 O.S. 2001, §§ 207(c) and 212(b).

2. “Sales of goods, wares, merchandise, tangible personal property, machinery and equipment to a manufacturer for use in a manufacturing operation” are specifically exempted from the levy of sales and/or use tax. 68 O.S. Supp. 2003, § 1359(1)⁹ and 68 O.S. 2001, § 1404(4)¹⁰.

3. “Manufacturing” is defined in pertinent part to mean and include “the activity of converting or conditioning tangible personal property by changing the form, composition, or quality of character of some existing material or materials, including natural resources, by procedures commonly regarded by the average person as manufacturing, compounding, processing or assembling, into a material or materials with a different form or use.” 68 O.S. Supp. 2007, § 1352(14).¹¹ See *OAC*, 710:65-13-150.1(a)(4).

4. A “Manufacturing Operation” is defined to mean “the designing, manufacturing, compounding, processing, assembling, warehousing, or preparing of articles for sale as tangible personal property” and does not include “administration, sales, distribution, transportation, site construction, or site maintenance.” 68 O.S. 2007, § 1352(15); and *OAC*, 710:65-13-150.1(a)(5).

⁹ Amended by Laws 2003, c. 472, § 15, to include the second sentence which provides:

Goods, wares, merchandise, property, machinery and equipment used in a nonmanufacturing activity or process as set forth in paragraph 9 [now 14] of Section 1352 of this title shall not be eligible for the exemption provided for in this subsection by virtue of the activity or process being performed in conjunction with or integrated into a manufacturing operation.

¹⁰ This section provides that use tax shall apply to the “use of tangible personal property * * * specifically exempted from taxation under Oklahoma Sales Tax Code”. (Citation omitted).

¹¹ Laws 2007, c. 155, § 4, which redesignated former paragraphs 1 through 27 as paragraphs 2 through 28. See Laws 2004, c. 5, § 64, which amended then paragraph 13 by inserting “including natural resources” and “by the average person” in the relevant language.

5. *OAC*, 710:65-19-60 provides:

Made-to-order and custom sales

Where persons contract to manufacture, compound, process or fabricate their materials into articles of tangible personal property according to the special order of their customers, the total receipts from the sales of such articles are subject to tax. The seller may not deduct any of his costs, nor can he deduct any of his charges for labor or services, which are an item of the production or fabrication costs of the article, to arrive at the amount of gross receipts subject to tax. Articles commonly made to order are curtains, draperies, tents, awnings, clothing, and slipcovers. The person making sales of made-to-order and custom made articles may purchase the materials which become a component or ingredient of their products tax exempt pursuant to a valid sales tax permit. The equipment, tools and supplies directly used or consumed in the production of such articles and not becoming a part thereof are subject to tax. (Emphasis added).¹²

6. Rules promulgated pursuant to the Administrative Procedures Act¹³, are presumed to be valid until declared otherwise by a court of competent jurisdiction. 75 O.S. 1991, § 306(C). They are valid and binding on the persons they affect, have the force of law and are prima facie evidence of the proper interpretation of the matter to which they refer. 75 O.S. 1991, § 308.2(C). Further, the legislature is deemed to adopt an administrative construction of a statute when, subsequent to such construction, it amends the statute or reenacts it without overriding such construction. *Branch Trucking Co. v. Oklahoma Tax Commission*, 1990 OK 41, 801 P.2d 686 (Okla. 1990).

7. In all administrative proceedings the burden of proof is on the taxpayer to show in what respect the action or proposed action of the Oklahoma Tax Commission is incorrect. *OAC*, 710:1-5-47. See *Enterprise Management Consultants, Inc. v. State ex rel. Oklahoma Tax Commission*, 1988 OK 91, 768 P.2d 359.

8. *OAC*, 710:65-19-60 specifically recognizes that the producer of made-to-order and custom made articles is a manufacturer by definition, but denies the status of a manufacturer by subjecting the “equipment, tools and supplies directly used or consumed in the production of such articles and not becoming a part thereof” to tax.

9. Protestant has failed to come forward with any evidence to show it is not primarily engaged in producing made-to-order and custom made articles. Accordingly, Protestant’s protest to the denial of the *Application* should be denied.

¹² Promulgated as Rule 13.016.24 of the Oklahoma Tax Commission Permanent Rules (June 30, 1990).

¹³ 75 O.S. 2001, § 250 et seq., § 301 et seq.

DISPOSITION

Based on the above and foregoing findings of fact and conclusions of law, it is ORDERED that the protest to the denial of the manufacturer sales tax exemption permit application of Protestant, COMPANY be denied.

OKLAHOMA TAX COMMISSION

CAVEAT: This decision was NOT deemed precedential by the Commission. This means that the legal conclusions are 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.

NOTE: The distinction between a Commission Order designated as “Precedential” or “Non-Precedential” has been blurred because all OTC Orders resulting from cases heard by the Office of Administrative Law Judges are now published, not just “Precedential” Orders. *See* OKLA. STAT. ANN. tit.68, § 221(G) (West Supp. 2009) and OKLA. STAT. ANN. tit. 75, § 302 (West 2002). *See also* OTC Orders 2009-06-23-02 and 2009-06-23-03 (June 23, 2009), which also conclude the language of the Statute is “clear and unambiguous.”