JURISDICTION: **OKLAHOMA TAX COMMISSION**
CITE: **2012-12-11-36 / NON-PRECEDENTIAL**
ID: **P-11-474-H**
DATE: **DECEMBER 11, 2012**
DISPOSITION: **SUSTAINED**
TAX TYPE: **SALES / MANUFACTURING EXEMPTION**
APPEAL: **NO APPEAL TAKEN**

ORDER

The above matter comes on for entry of a final order of disposition by the Oklahoma Tax Commission. Having reviewed the files and records herein, the Commission makes the following Findings of Fact and Conclusions of Law and enters the following order.

PROCEDURAL HISTORY

On July 5, 2011, the protest was filed with the Office of Administrative Law Judges for further proceedings consistent with the *Uniform Tax Procedure Code*[1] and the *Rules of Practice and Procedure Before the Office of Administrative Law Judges*.[2] On July 8, 2011, the Court Clerk[3] sent a memorandum to the Taxpayer Assistance Division requesting the protest file. On July 11, 2011, OTC ATTORNEY 1, First Deputy General Counsel, and OTC ATTORNEY 2, Assistant General Counsel, Office of General Counsel, Oklahoma Tax Commission, filed an Entry of Appearance as Co-Counsel for the Taxpayer Assistance Division of the Oklahoma Tax Commission. On July 13, 2011, a letter was mailed to ATTORNEY, FIRM, Counsel for the Protestant, advising the matter had been assigned to ALJ, Administrative Law Judge, and docketed as Case Number P-11-474-H. The letter also advised a Notice of Prehearing Conference would be sent by mail and enclosed a copy of the *Rules of Practice and Procedure Before the Office of Administrative Law Judges.*[4] On July 15, 2011, the Court Clerk received the protest file from the Division.

On September 8, 2011, the Notice of Prehearing Conference was mailed to Counsel, setting the prehearing conference for October 5, 2011, at 9:30 a.m.[5]

On October 5, 2011, the Division filed a Status Report In Lieu of Prehearing Conference. On October 7, 2011, a Joint Proposed Scheduling Order was filed with the Court Clerk. On October 12, 2011, the Scheduling Order was issued setting this matter for hearing on

[1] OKLA. STAT. ANN. tit. 68, § 201 *et seq.* (West 2001).

[2] OKLA. ADMIN. CODE §§ 710:1-5-20 through 710:1-5-47.

[3] OKLA. ADMIN. CODE § 710:1-5-10(c)(2) (June 25, 1999).

[4] *Id.*

[5] OKLA. STAT. ANN. tit. 68, § 208 (West Supp. 2012).

January 19, 2012, at 1:30 p.m., with pre-trial briefs or position letters due on or before January 12, 2012.

On December 22, 2011, Joint Stipulation of Facts and Issues were filed, with Exhibits A through D attached thereto.

On January 12, 2012, ATTORNEY contacted the Court Clerk by telephone and requested a one (1) day extension to file the Protestant's brief due to technical problems. OTC ATTORNEY 2 did not have any objections, so the request was granted.[6] On January 12, 2012, the Division's Memorandum Brief was filed. On January 13, 2012, the Protestant's Pretrial Brief was filed. On January 19, 2012, at 1:30 p.m., an open hearing[7] was held as scheduled. ATTORNEY made an Opening Statement on behalf of the Protestant. Before making an Opening Statement for the Division, OTC ATTORNEY 2 explained that the "Rework" area in Stipulation #14 was the same as the "Re-packaging" area in Stipulation #12. ATTORNEY was in agreement with OTC ATTORNEY 2'S explanation regarding Stipulations #12 and #14.

The Protestant called as its only witness, CEO, Chief Executive Officer ("CEO") of the Protestant,[8] who testified about the Protestant's business processes and practices. Protestant's Exhibit 1 was identified, offered, and admitted into evidence. The Division called as its first witness, FIELD AUDITOR, Field Auditor ("Field Auditor"),[9] Compliance Division of the Oklahoma Tax Commission, who testified about the processing and review of the Protestant's Oklahoma Business Registration Application for Manufacturers ("Application") and as custodian of the Division's records. The Division called its second witness, SR. VP. OPERATIONS, Senior Vice-President of Operations ("Sr. VP Operations") for the Protestant, who testified about the Protestant's Application and business processes and practices. The Division called as its last witness, ADMINISTRATOR, Administrator, Field Audit Section, Compliance Division of the Tax Commission, who testified about the processing and decisions made by the Division concerning the Application. OTC ATTORNEY 2 waived Closing Statement on behalf of the Division. ATTORNEY made a Closing Statement on behalf of the Protestant. At the end of the hearing, the record in this matter remained opened for the preparation of a written transcript at the request of ATTORNEY,[10] and for the parties to submit proposed findings of fact and conclusions of law.

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[6] *See* memorandum to court file.

[7] The Protestant, through ATTORNEY, waived its right to a confidential hearing as provided by the provisions of OKLA. STAT. ANN. tit. 68, § 205 (West Supp. 2012).

[8] CEO has been employed by the Protestant since 1978.

[9] FIELD AUDITOR has been employed by the Tax Commission as a Field Auditor for approximately thirty (30) years.

[10] On January 19, 2012, ATTORNEY filed a written Transcript Request with the Court Clerk.

On February 27, 2012, the "Original" transcript was filed with the Court Clerk. On February 29, 2012, the Court Clerk mailed a letter to ATTORNEY advising the "Original" transcript had been received with a balance due of $170.00.

On March 7, 2012, the Court Clerk received Check #015827 paying the balance due for the transcript in full. On March 7th, a representative from ATTORNEY'S office picked up a copy of the transcript and a copy of the transcript was also provided to OTC ATTORNEY 1 and OTC ATTORNEY 2. On March 8, 2012, a letter was mailed to Counsel advising proposed findings of fact and conclusions of law were to be filed on or before April 23, 2012, at which time the record in this matter would be closed and the case submitted for decision.

On April 12, 2012, the Protestant's *Proposed Findings of Fact and Conclusions of Law* (*"Proposed Findings")* were filed with the Court Clerk. On April 23, 2012, the Division's *Proposed Findings* were filed with the Court Clerk. The record in this matter was closed and this case submitted for decision on April 24, 2012.

On April 23, 2012, a Manufacturer's Sales Tax Exemption Permit (MSEP) was issued to the Protestant and mailed to protestant without any accompanying letter or other documentation.

On June 22, 2012 the Administrative Law Judge filed his Findings, Conclusions and Recommendations in this matter. The Administrative Law Judge found that the Protestant did not meet the definition of a manufacturer and Recommended the protest should be denied and the "Partial" MSEP which the Division proposes to issue should also be denied.

On July 9, 2012, Protestant filed a Motion for Hearing En Banc. The Division filed a Response to Protestant's Motion for Hearing En Banc on July 24, 2012. On October 4, 2012 the Commissioners of the Oklahoma Tax Commission issued an Order granting the Protestant's Motion for a Hearing En Banc and setting the date for the Hearing on November 20, 2012, at 1:30 p.m.

On November 20, 2012, at 1:30 p.m. a Hearing En Banc before the Commissioners of the Oklahoma Tax Commission was held as scheduled. ATTORNEY, FIRM, appeared on behalf of the Protestant and OTC ATTORNEY 1, First Deputy General Counsel, Oklahoma Tax Commission appeared on behalf of the Division.

STIPULATION OF FACTS

On December 22, 2011, the parties filed Joint Stipulation of Facts and Issues, with Exhibits A through D attached thereto,[11] as follows, to-wit:

1. Protestant designs socks, hosiery, and infant wear (collectively referred to as "product line(s)") for various name brands. In its design for seasonal product lines for multiple

[11] The text of the stipulated facts is set out *in haec verba*. "***in haec vega***" (in heek v<<schwa>>r-b<<schwa>>). [Latin] In these same words; verbatim. BLACK'S LAW DICTIONARY (9TH ed. 2009), available at http://westlaw.com.

licensees, Protestant includes all aspects of the product line, including the type and color of the cloth and thread to be used, as well as product packaging.

2. Once the design of the product line and product packaging is approved by the customer, Protestant contracts with an outside entity where the product line is woven. Protestant regularly receives product line samples which it tests for quality control purposes to ensure the product lines meet Federal, licensor and customer requirements regarding product safety, quality, and specifications.

3. Protestant also contracts with an outside entity which produces the product packaging. The product lines and product packaging are then shipped back to Protestant's facility located at PROTESTANT ADDRESS.

4. Protestant packages and ships the product line to specific customers, which can also include re-packing the product line into customer-specific product packaging designed by Protestant.

5. On or about January 12, 2011, Protestant submitted a Business Tax Registration Package applying for the manufacturing sales tax exemption permit ("MSEP") for its location at PROTESTANT ADDRESS. (Exhibit A.)

6. On or about February 10, 2011, Protestant received a denial letter in response to said application. (Exhibit B.)

7. On or about April 21, 2011, the Division conducted an on-site review of Protestant's facility.

8. After the initial on-site review, the Division upheld its initial decision to deny Protestant's MSEP application.

9. By letter dated July 1, 2011, Protestant protested the denial of its MSEP application. (Exhibit C.)

10. On August 1, 2011, the Division conducted an additional on-site review of Protestant's facility. Afterwards, the Division agreed to grant Protestant's MSEP for items used in the "design area" and the "re-packaging area." (Exhibit D.)

11. The "design area" is the area in Protestant's facility which consisted of eight cubicles equipped with the necessary computer hardware and software.

12. The "re-packaging area" is the area in Protestant's facility which consisted of two label printers and tables where Protestant's products were packaged.

13. Protestant claims purchases of the following items should be included in its MSEP: hosiery items, slippers, infant wear, packaging, displays, software, computers,

shipping boxes and supplies, fork lifts, conveyors, scales, warehouse racking, shrink wrappers, and miscellaneous warehouse equipment.

14. Additionally, Protestant claims the following areas are part of its manufacturing operation and, therefore, all items used in the areas should be included in the MSEP:

Department	Square Feet
Design	5,000
Purchasing	700
Inventory Control	200
Order Management	1,250
Warehouse	125,000
Rework	5,000[12]
Administration	2,000

STATEMENT OF ISSUES

At issue in this matter is whether Protestant's operations, other than the design area and re-packaging area which the Division has agreed to include in Protestant's MSEP, qualify as a "manufacturing operation" under 68 O.S. 2011, § 1352(15) such that Protestant qualifies for a sales tax exemption under 68 O.S. 2011, § 1359(1).

ADDITIONAL FINDINGS OF FACT

Upon review of the file and records, including the transcripts of the proceedings, the exhibits received into evidence, the briefs, the *Proposed Findings* submitted by the parties, and the Findings of Fact, Conclusions of Law and Recommendations filed by the Administrative law Judge on June 22, 2012 the undersigned finds:

1. The Protestant has never held an MSEP. The Protestant has always out-sourced all of the product weaving and customer-specific packaging production to outside entities, overseas or offshore, mostly in Asia, China, Korea, the Philippines, and Taiwan.[13]

2. After the product lines and customer-specific product packaging are returned to the Protestant's facility, the Protestant's employees package and re-package the product lines into PDQs,[14] which are generally put together in the 25,000 square foot warehouse space the Protestant has next to the 5,000 square foot re-work area.[15] A small percentage, two percent

[12] OTC ATTORNEY 2 announced at hearing that the "rework" area was the same as the "re-packaging area" referred to in Stipulation #12. Tr. at 7.

[13] Tr. at 13-14, and 25. *See* Stipulations 2-3.

[14] *See* Notes 17-18, *infra*.

[15] Tr. at 39-40. "Q. …they are flat and somebody has to take and open them and tape them and basically get them where stuff can be put in them? A. That is correct." Tr. at 44-45. It is possible there is a mistake in the

(2%) to three percent (3%) at most, is shipped directly to the customer or drop shipped through a facility in Carson, California.[16]

3. A PDQ is a shipper tray, which the Protestant's employees fold into shape (trays have die cuts)[17] and put product-lines into the PDQ. More specifically, a PDQ is a corrugated tray which houses a product; a retail selling item the Protestant's customers use to sell the product (a display).[18]

4. At hearing, the Division stated the PDQs qualify as "manufacturing" for purposes of the MSEP, regardless of where they are assembled in the Protestant's facility.[19]

5. After packaging or re-packaging, the PDQs are placed in cardboard boxes, which are comprised of plain, corrugated cardboard, for shipment to the customer. These cardboard boxes are not produced at the Protestant's facility, but are out-sourced.[20] The Division maintained that the plain cardboard shipping boxes are not part of a manufacturing operation as such items are used in the distribution of the products to Protestant's customers.

6. In its warehouse, the Protestant uses computers, forklifts, pallet racking, flow racking, scales, equipment, expandable rollers, skate rollers that go in front of all the pick lines, and computer equipment.[21]

7. FIELD AUDITOR, the Field Auditor who toured the Protestant's facility, testified that "They don't produce anything at that location. They do the design of the product and the layout of the product like they described. Everything they stipulated to what they do at the design area is pretty much what they do. But then after that, they don't do any production at the facility."[22]

8. After a second visit to the Protestant's facility, FIELD AUDITOR determined in conjunction with ADMINISTRATOR, Administrator of the Field Audit Section, that the design area and the repackaging area were used in manufacturing.[23]

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transcript. The square footage of the warehouse might be 125,000. *See* Exhibit A.

[16] Tr. at 19.

[17] Tr. at 45.

[18] Tr. at 39.

[19] Tr. at 56-59

[20] Tr. at 44-45.

[21] Tr. at 43-44.

[22] Tr. at 30-31.

[23] Tr. at 31.

9. The Protestant conceded at hearing that the sales and administration areas would not qualify for an MSEP.[24]

10. On February 17, 2011 Protestant filed a Claim for Refund in the amount of $48,040.05 for sales tax paid during the preceding three years on the purchase of boxes used to ship its product. The Claim for Refund characterizes the boxes as shipping supplies.[25]

11. On April 23, 2012, a Manufacturer Sales Tax Exemption Permit was mailed to Protestant without any accompanying letter or other documentation. The face of the permit indicates an effective date of October 31, 2000, and an expiration date of October 31, 2012. At some time subsequent to that date a "renewal" of the permit was mailed to Protestant which showed an effective date of October 31, 2000, and an expiration date of October 31, 2015.[26]

12. At the En Banc Hearing Counsel for the Division and Counsel for the Protestant agreed that the effective date for the MSEP should be January 12, 2011.

CONCLUSIONS OF LAW

1. The Oklahoma Tax Commission is vested with jurisdiction over the parties and subject matter of this proceeding.[27]

2. Sales of tangible personal property are taxable unless otherwise exempt by statute.[28] Specifically exempted from the tax levied by Section 1354 of Title 68, are the "sales of goods, wares, merchandise, tangible personal property, machinery and equipment to a manufacturer for use in a manufacturing operation." ("Manufacturer's Exemption Statute").[29]

3. "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, 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. "Manufacturing" does not include extractive industrial activities such as mining, quarrying, logging, and drilling for oil, gas and water, nor oil and gas

[24] Tr. at 63.

[25] Exhibit A to Protestant's Brief in Support filed November 5, 2012.

[26] Exhibit C to Protestant's Brief in Support filed November 5, 2012 and Tr. of En Banc Hearing, P 20-23.

[27] OKLA. STAT. ANN. tit. 68, § 212 (West 2001).

[28] OKLA. STAT. ANN. tit. 68, § 1354(A)(1) (West 2008).

[29] OKLA. STAT. ANN. tit. 68, § 1359(1) (West Supp. 2012). The statutory reference in Section 1359(1) has not been updated. It should reference paragraph 15, not paragraph 9 of Section 1352. *See* OKLA. STAT. ANN. tit. 68, § 1352(15) (West 2010).

field processes, such as natural pressure reduction, mechanical separation, heating, cooling, dehydration and compression.[30]

4. "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. Extractive activities and field processes shall not be deemed to be a part of a manufacturing operation even when performed by a person otherwise engaged in manufacturing.[31]

5. "Manufacturing site" means a location where a manufacturing operation is conducted, including a location consisting of one or more buildings or structures in an area owned, leased, or controlled by a manufacturer.[32]

6. Section 1359(1) of Title 68[33] provides for an exemption from sales tax of certain property for use in a manufacturing operation as follows.

> 1. Sales of goods, wares, merchandise, tangible personal property, machinery and equipment to a manufacturer for use in a manufacturing operation. Goods, wares, merchandise, property, machinery and equipment used in a nonmanufacturing activity or process as set forth in paragraph 9 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.
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> For the purposes of this paragraph, sales made to any person, firm or entity that has entered into a contractual relationship for the construction and improvement of manufacturing goods, wares, merchandise, property, machinery and equipment for use in a manufacturing operation shall be considered sales made to a manufacturer which is defined or classified in the North American Classification System (NAICS) Manual under Industry Group No. 324110. Such purchase shall be evidenced by a copy of the sales ticket or invoice to be retained by the vendor indicating that the purchases are made for and on behalf of such manufacturer and set out the name of such manufacturer as well as include a copy of the Manufacturing Exemption Permit of the manufacturer. Any person who wrongfully or erroneously certifies that purchases are being made on behalf of such manufacturer or who otherwise violates this paragraph shall be guilty of a misdemeanor and upon conviction thereof shall be fined an

[30] *Id. See* OKLA. ADMIN. CODE § 710:65-13-150.1(a)(4) (July 11, 2010.)

[31] OKLA. STAT. ANN. tit. 68, § 1352(15) (West 2008). *See* OKLA. ADMIN. CODE § 710:65-13-150.1(a)(5) (July 11, 2010.)

[32] OKLA. STAT. ANN. tit. 68, § 1352(16) (West 2008).

[33] OKLA. STAT. ANN. tit. 68, § 1359(1) (West 2008).

amount equal to double the amount of sales tax involved or incarcerated for not more than sixty (60) days or both;[34]

7. Section 1359.2 of Title 68,[35] ("MSEP Statute") provides as follows, to-wit:

A. In order to qualify for the exemption authorized in paragraph 1 of Section 1359 of Title 68 of the Oklahoma Statutes, at the time of sale, the person to whom the sale is made, provided the purchaser is a resident of this state, shall be required to furnish the vendor proof of eligibility for the exemption as required by this section. All vendors shall honor the proof of eligibility for sales tax exemption as authorized under this section, and sales to a person providing such proof shall be exempt from the tax levied by Section 1350 et seq. of Title 68 of the Oklahoma Statutes.

B. Each resident manufacturer wishing to claim the exemption authorized in paragraph 1 of Section 1359 of Title 68 of the Oklahoma Statutes shall be required to secure from the Oklahoma Tax Commission a manufacturer exemption permit, the size and design of which shall be prescribed by the Tax Commission. This permit shall constitute proof of eligibility for the exemption provided in paragraph 1 of Section 1359 of Title 68 of the Oklahoma Statutes. Each such manufacturer shall file with the Tax Commission an application for an exemption permit, setting forth such information as the Tax Commission may require. The application shall be signed by the owner of the business or representative of the business entity and as a natural person, and, in the case of a corporation, as a legally constituted officer thereof.

C. Each manufacturer exemption permit issued shall be valid for a period of three (3) years from the date of issuance. If a manufacturer applying for a manufacturer exemption permit is already the holder of a manufacturer's sales tax permit issued under Section 1364 of Title 68 of the Oklahoma Statutes at the time of initial application, the manufacturer exemption permit shall be issued with an expiration date which corresponds with the expiration date of the manufacturer's sales tax permit. Thereafter, the Tax Commission shall issue the exemption permits at the same time of issuance or renewal of the manufacturer's sales tax permit issued under Section 1364 of Title 68 of the Oklahoma Statutes.

D. The Tax Commission shall honor all manufacturer's limited exemption certificates issued prior to the effective date of this act. However, holders of such certificates shall apply for a manufacturer exemption permit pursuant to

[34] The reference to paragraph 9 of Section 1352 is meant to reference the definition of "manufacturing", now codified at paragraph 15 of Section 1352. It was added by HB 1356 in the 2003 legislative session when the definition of "manufacturing", now codified at paragraph 15, was then codified at paragraph 9.

[35] OKLA. STAT. ANN. tit. 68, § 1359.2 (West 2008). (Footnotes omitted.)

> the provisions of this section at the same time they apply for issuance or renewal of a manufacturer's sales tax permit.

8. The rules promulgated pursuant to the Administrative Procedures Act are presumed to be valid and binding on the persons they affect and have the force of law.[36]

9. "Administration" means activities performed in the areas of general management, communications, security, employee training, personnel administration, including time-keeping, general accounting and purchasing, employee benefit activities and employee recognition, legal services, public relations, and the establishment, maintenance, billing and collection of accounts.[37]

10. "Distribution" means those activities involved in the movement of manufactured items by vehicles, aircraft, watercraft, railroads or pipelines from a manufacturing site to a customer's location.[38]

11. Purchases by a manufacturer of tangible personal property or services for use in a manufacturing operation are exempt from sales and use taxes in Oklahoma.[39]

12. Operations performed by a sub-contractor to the manufacturer may also qualify as a manufacturing operation if the contractor is performing sub-assembly work leading to completion of the finished product.[40]

13. Activities included in a manufacturing operation include shipping. Examples of shipping supplies eligible for exemption when purchased by a manufacturer include boxes, scales and inserts.[41]

14. Statutes are interpreted to attain that purpose and end[42] championing the broad public policy purposes underlying them.[43] Only where the legislative intent cannot be ascertained from the statutory language, i.e. in cases of ambiguity or conflict, are rules of

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[36] OKLA. STAT. ANN. tit. 75, § 250 *et seq.* (West 2002). *See Toxic Waste Impact Group, Inc. v. Leavitt*, 1988 OK 20, 755 P.2d 626.

[37] OKLA. ADMIN. CODE § 710:65-13-150.1(a)(1) (July 11, 2010).

[38] OKLA. ADMIN. CODE § 710:65-13-150.1(a)(2) (July 11, 2010).

[39] OKLA. ADMIN. CODE § 710:65-13-150.1(b) (July 11, 2010).

[40] *Id.*

[41] *Id*.

[42] *Keating v. Edmundson*, 2001 OK 110, 37 P.3d 882, ¶8. (Citations omitted).

[43] *Id.* at ¶8.

statutory construction employed.[44] However, where the statutory language is ambiguous or uncertain, a construction is applied to avoid absurdities.[45] Statutory construction presents a question of law.[46]

15. Tax exemptions, deductions, and credits depend entirely on legislative grace and are strictly construed against the exemption, deduction, or credit.[47]

16. Business engaged in manufacturing does not lose its tax status as manufacturer merely because it conducts some nonmanufacturing activities.[48]

17. It is the production process as a whole that must be recognized as manufacturing, not each of its individual component parts.[49]

18. An entity's status as a manufacturer is not defeated by the fact that certain specialized tasks are performed by outside contractors.[50]

19. In all proceedings before the Tax Commission, unless otherwise provided by law, the taxpayer has the burden of proof.[51]

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[44] *Id.* at ¶8.

[45] *Id.* at ¶8.

[46] *Blitz U.S.A., Inc. v. Oklahoma Tax Com'n*, 2003 OK 50, 75 P.3d 883.

[47] *TPQ Inv. Corp. v. State ex rel. Oklahoma Tax Com'n*, 1998 OK 13, ¶8, 954 P.2d 139.

[48] *Schulte Oil Co., Inc. v. Oklahoma Tax Com'n, 1994 OK 103, 882 P.2d 65.*

[49] *Dolese Bros. v. State ex rel. Oklahoma Tax Com'n*, 2003 OK 4, 64 P.3d 1093.

[50] *United Design Corp. v. State ex rel. Oklahoma Tax Com'n, 1997 OK 43, 942 P.2d 725*.

[51] OKLA. ADMIN. CODE § 710:1-5-47 (June 25, 1999):

> In all administrative proceedings, unless otherwise provided by law, the burden of proof shall be upon the protestant to show in what respect the action or proposed action of the Tax Commission is incorrect. If, upon hearing, the protestant fails to prove a prima facie case, the Administrative Law Judge may recommend that the Commission deny the protest solely upon the grounds of failure to prove sufficient facts which would entitle the protestant to the requested relief.

OKLA. ADMIN. CODE § 710:1-5-77(b) (June 25, 1999), provides in pertinent part:

> "…preponderance of the evidence" means the evidence which is of greater weight or more convincing than the evidence which is offered in opposition to it; evidence which as a whole shows that the fact sought to be proved is more probable than not.

DISCUSSION AND ANALYSIS

Several sections of title 68 of the Oklahoma Statutes provide authority entitling a person to a hearing before the Oklahoma Tax Commission.[52] This case was docketed by the Office of the Administrative Law Judges as a protest to the denial of an Application for a Manufacturer Sales Tax Exemption. Section 212 of Title 68 of the Oklahoma Statutes provides authority entitling a person to a hearing before the Commission when issuance of a license or permit is refused.

During the pendency of this matter the Taxpayer Assistance Division of the Oklahoma Tax Commission issued a Manufacturer Sales Tax Exemption Permit to the protestant.[53] The issuance of a permit would normally render a protest to the denial of an Application for such a permit moot and could result in the dismissal of the protest pursuant to the Administrative Rules of the Commission.[54] This case however presents an unusual situation.

Tax Commission Rule OAC 710:1-5-46 provides authority for the Commission to dismiss a protest as moot. This authority is permissive and not mandatory. Neither the Taxpayer nor the Division has asked that this case be dismissed as moot. Because of the unique facts and circumstances of this case the Commission has decided not to dismiss this case as moot.

On February 17, 2011, protestant filed a claim for refund of sales taxes paid on purchases of cardboard boxes. Protestant characterized the boxes as "shipping supplies" and indicated its goods are packed and shipped in such boxes.[55] There is nothing in the record which indicates that the Oklahoma Tax Commission has taken any official action in writing on this claim for refund. Several months after this claim for refund was filed and after the protest to the denial of the Application for a permit was filed, Protestant was advised in writing by legal counsel for the Compliance Division that the Division had determined that manufacturing occurs in the design area and the repackaging area of the facility and would grant an MSEP to be used for items in those areas. The letter also advised

> It is the Division's position that the remainder of Protestant's operation is "distribution" which is specifically exempted from the definition of a "Manufacturing operation" by 68 O.S. Supp. 2010, §1352(15) and is thus outside the manufacturing exemption found in Section 1359(1).

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[52] *See, e.g.* Sections 207, 212, 221, 227 and 228.

[53] *See* Finding of Fact 14, *supra*; Brief of the Compliance Division filed November 5, 2012 at p. 2; and Protestant's Brief in Support filed November 5, 2012 at p. 2.

[54] OKLA. ADMIN. CODE § 710:1-5-46 (B) (June 11, 2005):

[55] Exhibit A to Protestant's LLC's Brief in Support filed November 5, 2012.

In as much as the Protestant's claim for refund could likely not prevail under the position set forth in the Division's letter of August 11, 2011, it is understandable that Protestant would treat this proceeding as including a denial of its claim for refund and seek to obtain a final determination and order of the Commission with regard to the legal issues relevant to such claim. Additionally, after the Protestant received the Manufacturer's Sales Tax Exemption Permit, the Administrative Law Judge filed Findings of Fact, Conclusions of Law and Recommendations in this matter which recommended the protest in this matter be denied and Protestant not receive an MSEP.

Although the advice of an employee of the Tax Commission is not the type of "action" for which a hearing may be granted, the unique facts and circumstances of this case support the issuance of an order by the Commission in this matter.

The Protestant's position is that the Division construed the relevant manufacturing exemption too narrowly resulting in the limited approval of Protestant's MSEP Application to the design area and re-packaging area.[56] ATTORNEY elaborated on the Protestant's position in his opening and closing statements before the Administrative Law Judge,[57] which in pertinent parts are as follows, to-wit:

> What is at issue here is whether the manufacturing process can be parsed out into different pieces, can it be separated into discrete components and then separately classified as manufacturing or nonmanufacturing or separate a part of the process in the distribution process.
>
> It's our contention, and we believe that supported by Oklahoma case law going back as long as forty years, that the manufacturing process is a single process.
>
> **...**
>
> …this case is really about when the manufacturing process starts and stops. And what is included, whether it is a process that is a complete process or whether it can be broken down into discrete parts and some of it approved and some of it not approved.
>
> **...**
>
> And that is that the manufacturing process is a single process. Whether a piece of it is subcontracted out or not, the case law has not changed on that. Whether it is simply an assembly and nothing is actually physically manipulated at a particular facility is not an issue.
>
> **...**

[56] Protestant's Brief at 3.

[57] Tr. at 6, and 62-63. *See* Protestant's Brief at 6.

> We contend that everything we do at our facility in Oklahoma City, and we will concede that sales and administration should be excluded from that, that everything we do there is a part of the manufacturing process, including what is done in the warehouse.

The Division's position is that it correctly limited the approval of Protestant's MSEP Application to items purchased for use in the design area and re-packaging area.[58] The Division addressed its position in more detail, as follows,[59] to-wit:

> In order to qualify for the manufacturing exemption, a taxpayer must meet two criteria: (1) it must be a manufacturer and (2) it must have a manufacturing operation. Logic dictates that in order to have a manufacturing operation, one must first be a manufacturer. [Protestant] does not qualify as a manufacturer for the vast majority of its operations that relate to distribution, sales, and administration. None of the product lines are woven and none of the customer specific packaging is produced at [Protestant's] Oklahoma City facility. [Protestant's] activities of palletizing, shrink-wrapping, and shipping of products received from subcontractors does not convert or condition those products by 'changing the form, composition, or quality of character' of the materials. The only part of the manufacturing process which occurs at [Protestant's] facility is the design of the product lines and product packaging and the placement by hand of such product lines into the customer specific packages. Every other operation occurring at [Protestant's] facility is distribution, sales, or administration which [is] all specifically excepted from the manufacturing exemption. For these reasons, the Division correctly limited the MSEP to the design and repackaging areas of [Protestant's] facility.

The parties stipulated that the issue[60] in this matter was as follows, to-wit:

> At issue in this matter is whether Protestant's operations, other than design area and re-packaging area which the Division has agreed to include in Protestant's MSEP, qualify as a "manufacturing operation" under 68 O.S. 2011, § 1352(15) such that Protestant qualifies for a sales tax exemption under 68 O.S. 2011, § 1359(1).

Prior to the amendments to the relevant statutes in 1998 the general rule in Oklahoma was that "…manufacturing operations cannot be segmented into their individual pieces but must be evaluated as one continuous process."[61] In *United Design*, the Court noted the *Schulte*

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[58] Division's Brief at 3.

[59] Division's Brief at 6. (Citations omitted.) *See* Division's *Proposed Findings* at 6-7.

[60] *See* Stipulation #15.

[61] Protestant's *Proposed Findings* at 5.

opinion reasoned "[t]he § 1359 sales tax exemption should receive a practical construction-one that *would not allow* a manufacturing operation that is in fact one continuous and integrated production process to be chopped up into discrete segments."[62] (Emphasis added.)

Prior to the enactment of House Bill No. 2754 in the 1998 Legislative Session, Section 1359(1) of title 68 provided for an exemption from sales tax for manufacturing as follows

> 1. 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; (*emphasis added*)

The 1998 amendment deleted all of the above language and replaced it with

> 1. Sales of goods, wares, merchandise, tangible personal property, machinery and equipment to a manufacturer for use in a manufacturing operation;
>
> 2. The legislation also added definitions for "manufacturing operation" and "manufacturing site" and amended the definition of "manufacturing" as follows;

~~(I)~~ 9. "Manufacturing" means and includes ~~every operation commencing with the first production stage of any article of tangible personal property and ending with the completion of tangible personal property having the physical properties which it has when transferred by the manufacturer to another.~~ 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;

10. "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;

11. "Manufacturing site" means a location where a manufacturing operation is conducted, including a location consisting of one or more buildings or structures in an area owned, leased, or controlled by a manufacturer;

[62] *United Design Corp. v. State ex rel. Oklahoma Tax Com'n, 1997 OK 43, 942 P.2d 725.*

Prior to the 1998 legislation there was no requirement for a manufacturer to obtain a permit in order to be eligible for the sales tax exemption. Court cases decided before 1998 have only limited usefulness in deciding whether an MSEP should be granted. The Division has agreed, and the evidence supports a finding that some parts of Protestant's operation meet the definition of a manufacturing operation under the current statutory definition of a manufacturing operation. Section 1359.2 provides for the issuance of a manufacturer exemption permit. It does not contain a requirement that an establishment be engaged primarily in a manufacturing operation in order to be eligible for a permit.

The determination of whether an MSEP should be issued does not turn on whether some of the manufacturing operation is performed by outside contractors. The Oklahoma Supreme Court has held that an establishment's status as a manufacturer is not defeated by the fact that some manufacturing tasks were performed by outside contractors.[63] There is no provision of law which requires a majority of the manufacturing operations of an establishment to be performed in-house. Prior to the 1998 legislation there was a definition of the term "manufacturing plant" which included the word "primarily". That definition no longer exists and none of the relevant terms now use the word "primarily" in their definition.

Before 1998 the Oklahoma Statues defined manufacturing plants to mean

Those establishments **primarily** engaged in manufacturing or processing operations, and generally recognized as such.

That definition was deleted by amendments enacted by the 1998 session of the Oklahoma Legislature. The Oklahoma Statutes no longer contain a requirement that an establishment be primarily engaged in manufacturing operations in order to qualify for an MSEP. The statutes now provide for an exemption from sales tax for sales of certain items to a manufacturer for use in a manufacturing operation. The statute specifically exclude from the exemption sales of items used in a nonmanufacturing activity. The statutory definition of manufacturing operation describes the type of activities which are part of a manufacturing operation and specifically identifies certain activities as being excluded from the definition of manufacturing operation.[64]

Because protestant outsources some of the manufacturing process this case presents unique issues regarding what activities qualify for the manufacturer sales tax exemption. Protestant outsources the weaving and initial packaging of its products to outside contractors. It receives this product at its business location in Oklahoma City. Some of this product is repackaged and some is not. The Division's position is that for all of the product which is not repackaged at Protestant's business location in Oklahoma City the "back door" of the manufacturing process is at the location of the subcontractor and not in Oklahoma City. Section 1352(15) specifically provides that a manufacturing operation ends at the point where a finished product leaves the manufacturing site. The Division argues that, for products which are not repackaged in Oklahoma City the only thing which occurs in Oklahoma City is distribution,

[63] *Id.*

[64] OKLA. STAT. ANN. tit. 68, § 1352(15) (West 2008).

which is specifically excluded by Section 1352(15) of Title 68 from the definition of a "manufacturing operation", and consequently by Section 1359(1) of Title 68 from the exemption from sales tax.

Protestant points out that the Administrative Rule of the Oklahoma Tax Commission provides that activities included in a manufacturing operation include warehousing supplies and shipping. His position is, essentially, that the "back door" of the manufacturing operation is when Protestant's product leaves its "manufacturing site" in Oklahoma City because the statute includes "warehousing" as being part of a manufacturing operation and the Administrative Rules have determined that shipping supplies are eligible for exemption when purchased by a manufacturer. Under the particular facts and circumstances of this case we conclude that the fact that some of the Protestant's manufacturing activities are outsourced does not prevent purchases of goods, wares, merchandise, tangible personal property, machinery and equipment for use in the warehousing and shipping of Protestant's products from being eligible for the statutory exemption from sales taxes.

The fact that an establishment is eligible for a permit does not mean that all purchases made by such establishment are exempt from sales tax. The question of what purchases made by a permit holder are exempt from sales tax must be answered by reference to the provisions of Section 1359(1) of Title 68 which provides for the tax exemption, Section 1352(15) of Title 68 which defines the term "manufacturing operation" and the Administrative Rules of the Oklahoma Tax Commission.[65]

Section 1359(1) provides an exemption from sales tax for the following sales.

> 1. Sales of goods, wares, merchandise, tangible personal property, machinery and equipment to a manufacturer for use in a *manufacturing operation*. Goods, wares, merchandise, property, machinery and equipment used in a nonmanufacturing activity or process as set forth in paragraph 9 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. (*emphasis added*)

Section 1352(15) defines the term "manufacturing operation"

> 15. "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. Extractive activities and field processes shall not be deemed to be a part of a manufacturing operation even when performed by a person otherwise engaged in manufacturing;

[65] OKLA. ADMIN. CODE § 710:65-13-150.1 (July 11, 2010).

OAC 710:65-13-150.1(b) provides examples of activities included in a manufacturing operation. Paragraph (6) provides as follows:

> (6) **Shipping**. Examples of shipping supplies eligible for exemption when purchased by a manufacturer include:
>
> (A) Boxes, scales, inserts.
> (B) Tape dispensers.

We conclude that, for this Protestant, under the unique facts and circumstances of this case, boxes of the type described by the Protestant in its February17, 2011, Application for Refund of Sales Tax are goods eligible for purchase exempt from the imposition of sales Tax by Protestant as a holder of a Manufacturer Sales Tax Exemption permit. Although we agree with Protestant that the cardboard boxes identified in its claim for refund qualify as shipping supplies eligible for exemption for the purpose of the Administrative Rule, the parties' agreement at the en banc hearing of the effective date of Protestant's MSEP precludes consideration of refund of sales tax on purchases made prior to that date.

ORDER

It is hereby ordered that, based on the facts and circumstances of this case, the protest is sustained. A Manufacturer Sales Tax Exemption Permit (MSEP) is issued to Protestant effective January 12, 2011.

The permit issued to Protestant entitles the Protestant to make purchases of goods, wares, merchandise, tangible personal property, machinery and equipment for use in designing, manufacturing, compounding, processing, assembling, or warehousing of articles for sale as tangible personal property exempt from the imposition of sales tax. The statute does not exempt from the imposition of sales tax the purchase of goods, wares, merchandise, tangible personal property, machinery or equipment for use in administration, sales, distribution, transportation, site construction or site maintenance.

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."