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STATE OF NORTH CAROLINA

COUNTY OF WAKE

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IN THE OFFICE OF
ADMINISTRATIVE HEARINGS
13 REV 18654

Office of
Administrative Hearings

MIDREX TECHNOLOGIES, INC.,)
)
 Petitioner,)
)
 v.)
)
)
 N.C. DEPARTMENT OF REVENUE,)
)
 Respondent.)

**FINAL DECISION AND ORDER
GRANTING RESPONDENT'S
MOTION FOR SUMMARY
JUDGMENT**

THIS MATTER came on to be heard before the undersigned Administrative Law Judge, Craig Croom, on July 7, 2014 in Raleigh North Carolina, for consideration of Petitioner's Motion for Summary Judgment and Respondent's Motion for Summary Judgment. Having considered the respective submissions of the parties and matters of record proper for consideration of this pending motion, the undersigned concludes that there is no genuine issue of material fact and that, therefore, summary judgment in favor of Respondent is appropriate.

APPEARANCES

For Petitioner: Thomas Holderness
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For Respondents: Tenisha Jacobs
N.C. Department of Justice
P.O. Box 629
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ISSUE

Whether Petitioner was engaged in business as a building or construction contractor and therefore entitled to utilize the single-factor apportionment methodology for excluded corporations set forth in N.C. Gen. Stat. § 105-130.4(r) to determine its North Carolina corporate income and franchise tax liability during the Period at Issue?

N.C. DEPT. OF JUSTICE
ATTORNEY GENERALS OFFICE

OCT 13 2014

RECEIVED
REVENUE SECTION

PROCEDURAL HISTORY

On 30 August 2013, Respondent, North Carolina Department of Revenue (“Department”), issued a Notice of Final Determination (“Final Determination”) denying Petitioner’s claim for refund of North Carolina corporate income and franchise taxes for tax years 2005 through 2008 (“Period at Issue”). Pursuant to N.C. Gen. Stat. §§ 105-105-241.15 and 150B-23(a), Petitioner, Midrex Technologies, Inc. (“Midrex”), filed a Petition for Contested Case Hearing (“Petition”) in the Office of Administrative Hearings (“OAH”) on 25 October 2013 challenging the Final Determination. Subsequent to filing the Petition, Petitioner and Respondent each filed a motion for summary judgment (collectively “Motions”) along with various other items of supporting documentation, including memorandums, affidavits, and depositions. On 7 July 2014, the parties appeared in the OAH and the Court heard oral arguments on the Motions. Upon consideration of the pleadings, exhibits, memorandums of law filed by the parties, and other matters of record, including the Petition and Final Determination, as well as having heard the arguments of counsel, the undersigned finds that this matter is ripe for disposition.

UNCONTROVERTED FACTS

I. BACKGROUND OF MIDREX

1. Midrex was initially formed as a division within the Midland-Ross Corporation to exploit the market potential of what is currently known as the Midrex Direct Reduction Process (“Midrex Process”). Midrex is headquartered in Charlotte, North Carolina.
2. The Midrex Process converts iron ore into direct reduced iron (“DRI”), a premium iron used as an alternative feed for steel and is utilized in a facility or module known as a Midrex Plant. This process is patented and has remained virtually unchanged for the past 40 years.
3. A Midrex Plant can take one to two years to design and is comprised of various parts and components (e.g., a furnace, heat recovery flute). A Midrex Plant is designed at Midrex’s Charlotte office. A Midrex Plant either utilizes natural gas or coal as its source for running the Midrex Process.
4. In 1983, Midrex was acquired by Kobe Steel Ltd. (“Kobe”). Upon purchasing the company, Kobe became the owner of the patents and proprietary rights associated with the Midrex Process and granted Midrex a license to utilize the Midrex Process. Kobe has also granted similar licenses to two other companies, Siemens VAI (“VAI”) and SMS Siemag.
5. The company employs “30 people . . . in [its Research and Development] center” that work on the “technology portion” of a Midrex Plant, as well as individuals in its “very large purchasing group that purchases a lot of equipment for [plants]” and a “large number of engineers designing” the various aspects of the plant. *30(b)(6) Deposition of Midrex (David R.*

Hamilton as designated representative), p. 36-37. Midrex's capital investments consist of computers, software, and its Research and Development facility. *Id.* at 70.

6. Midrex admits that its "primary business is selling . . . plants" *Id.* at 36.
7. During the Period at Issue, Midrex was involved in the following Midrex Plant sales:
 - Nu-Iron
 - LGOK
 - LION
 - Al-Tuwairqi
 - Acindar
 - Shaeed
 - MND
 - Hassed
 - Qasco

II. MIDREX'S BUSINESS ACTIVITIES AND OPERATIONS

8. Midrex essentially operates in three primary business segments: (a) Engineering Services and Procurement Services, (b) Midrex Plant Sales (which encompasses Advisory/Field Services), and (c) After Market Sales.

A. Engineering Services and Procurement Services

9. Midrex's engineering services primarily revolve around designing the systems and components of a Midrex Plant. Examples of the specific types of design work associated with a Midrex Plant include:

- Designing refractory linings for gas based equipment, furnaces, ductwork, and heating exchange equipment;
- Designing gas based equipment, furnaces, ductwork, and heating exchange equipment; and
- Designing systems and equipment associated with the design and construction of DRI plants and new technology innovation

10. During the Period at Issue, Midrex's engineering services were performed by individuals in its Engineering division who held job titles such as "Refractory Specialists," "Equipment Specialists," "Mechanical Engineers" and "Mechanical Designers.

11. The Engineering division was comprised of groups representing various engineering disciplines (*e.g.*, civil, mechanical, process, electrical/instrumentation).

12. Midrex's procurement services consisted of procuring non-proprietary and proprietary equipment associated with the Midrex Plant and were performed, in part, by individuals in its Procurement and Logistics division.

13. The Procurement and Logistics division also included the following two positions: Site Manager and Construction Manager.

14. The Site Manager was the person at the Midrex Plant site that handled the relationship with the purchaser of the Midrex Plant ("the Client") by keeping them apprised of issues or problems arising on a Midrex Plant site, which included any need for the Client to take corrective action or measures. Furthermore, the Site Manager coordinated the site, communicated with customers and workers and was responsible for all related on-site activities required for construction.

15. The Construction Manager was generally responsible "for *all related activities* required for the construction of large industrial plants in both foreign and domestic locations." See Appendix to Respondent's Memorandum in Support of Motion for Summary Judgment ("Appendix"), Tab 6 at MID-08666 (position description for "Construction Manager"). Added around 2007, Midrex created the position, in part, due to their clients' expectations regarding Midrex's involvement in the sale of a Midrex Plant. The person currently serving in the Construction Manager position is functioning in the field as Site Manager.

(B) Midrex Plant Sales

16. As a licensee of the Midrex Process, Midrex is authorized to design and sale a Midrex Plant, "huge part of [Midrex's] business." *30(b)(6) Deposition of Midrex (David R. Hamilton as Designated Representative)*, p. 73.

17. In order to define the terms and conditions of the sale of equipment and services for a particular Midrex Plant project, Midrex entered into contractual agreements. ("Plant Sale Contracts").¹ During the Period at Issue, the parties to the Plant Sale Contracts included Midrex, the Client, and, at times, Kobe and VAI.

18. The Plant Sale Contracts included terms relating to the technical specifications for the Midrex Plant, payment terms, and warranties provisions. The contracts also included terms specifically delineating the scope of work to be performed by the parties to the contract.

19. Midrex's scope of work under the Plant Sale Contracts did not include the actual construction, erection, and installation of the systems and components associated with the Midrex Plants. These tasks fell within the scope of work for the Client or an entity other than Midrex, such as Kobe or VAI.

¹ For purposes of this Final Decision, the term "Plant Sale Contract" includes agreements for the purchase of equipment and services and for the provision of field services (*e.g.*, Advisory Services Agreements, Technical Assistance Agreements).

20. To fulfil their obligations under the Plant Sale Contracts relating to the construction, erection, and installation of the systems and components associated with the Midrex Plants, the Client, or an entity other than Midrex, hired construction contractors and laborers to complete such tasks. The construction contractors had their own offices on the Midrex Plant site, supervision, and quality control people.

21. Midrex's core scope of work in any Plant Sale Contract consisted of the provision of the following services: (a) Engineering, *see supra*; (b) Procurement of equipment, *see supra*, and (c) Advisory/Field Services.

22. Midrex's field services generally involved the provision of technical advice, within specified limitations, relating to the construction, commissioning, training, and start-up of a Midrex Plant. The scope of the field services Midrex provided on any given project was set out in the Plant Sale Contracts. Among the types of field services provided by Midrex included:

- Interpretation and explanation of drawings, bills of material, specifications and other technical data;
- Providing advice to the Client or his contractor in developing and updating a construction sequence schedule for the orderly assembly and erection of the plant;
- Timely field inspection of the material, equipment, and workmanship after its arrival on the job site; and
- Providing advice relating to the commissioning of a Midrex Plant.

23. Generally, the Plant Sale Contracts often refer to field service personnel as "Construction Advisors" or "Commissioning Advisors." In addition to Midrex personnel, other vendors were also on site to provide field services during the construction of a Midrex Plant relating to the equipment they supplied for the project.

24. Twenty-five to thirty percent of Midrex's field services are provided by its "in-house" employees located within the Engineering and Procurement and Logistics divisions. *30(b)(6) Deposition of Midrex (Paul L. Carter, Jr. as Designated Representative)*, p. 31. The remainder of Midrex's field services are performed by contractors hired by Midrex and sent to the Midrex Plant Site. The majority of the contractors have a background in engineering.

25. Generally, the majority of Midrex's field service personnel were on site towards the middle of a Midrex Plant project term and performed field services related to the commissioning of the plant. The exact number of field service personnel provided by Midrex for a particular Midrex Plant project, as well as when they are needed on site, is specifically addressed in the Plant Sale Contracts.

26. In the course of performing field services, Midrex field service personnel were called upon to provide hand-on assistance to the laborers hired by the Client or an entity other than

Midrex. Nonetheless, per the Plant Sale Contract, the Client or the contractor was ultimately “responsible to provide direct craft supervision of all work performed, in order to achieve the schedule and quality control.” *30(b)(6) Deposition of Midrex (Donald R. Lyles as Designated Representative)*, p. 104; *Appendix*, Tab 22 at MID-05264. The Plant Sale Contracts further provided that the advice rendered by Midrex’s field service personnel did “not relieve the Client or his Contractor(s) of their responsibilities to perform the work as per the drawing and/or specifications” rendered by Midrex in the course of designing the Midrex Plant. *Id.* at 104; *see also, e.g., Appendix*, Tab 22 at MID-05264; Tab 25 at MID-04085.

(C) After Market Sales

27. Midrex’s aftermarket sales activities include the provision of additional equipment and parts relating to the operation of an existing Midrex Plant.

IV. REFUND CLAIM FOR THE PERIOD AT ISSUE

28. During the Period at Issue, Midrex filed a series of North Carolina C Corporation Tax Returns (“State Tax Returns”) with the Department. Among those filed were Midrex’s original returns for tax years 2005 through 2007 (collectively “Original Returns”). On the Original Returns, Midrex did not apportion its State franchise or corporate income tax, but instead, filed as a 100% domestic corporation.

29. After filing the Original Returns, Midrex filed its original tax year 2008 State Tax Return and amended its tax years 2005 through 2007 State Tax Returns apportioning its State franchise and income tax using the Standard Three-Factor Apportionment Formula (collectively “Three-Factor Apportionment Returns”). Midrex filed Three-Factor Apportionment Returns after coming to the realization that it was allowed to apportion for State corporate income and franchise tax purposes with the assistance of KPMG, Midrex’s accounting firm.

30. Subsequent to filing the Three-Factor Apportionment Returns, Midrex once again filed another set of amended State Tax Returns for tax years 2005 through 2008. Forming the basis of the refund claim at issue in this contested case, these amended returns were filed “to recompute the apportionment formula under the methodology applicable to excluded corporations” (collectively “Excluded Corporation Amended Returns”). *See 30(b)(6) Deposition of Midrex (David R. Hamilton as Designated Representative)*, pp. 29-30.

31. Midrex filed the Excluded Corporation Amended Returns after KPMG alerted Midrex that it believed Midrex was an excluded corporation. KPMG’s conclusion was based on its determination that Midrex was engaged in business as a building or construction contractor.

32. Since filing the Excluded Corporation Amended Returns, Midrex has not filed any State Tax Returns with the Department apportioning its State corporate income or franchise tax liability as an excluded corporation.

33. On all of its State Tax Returns filed during the Period at Issue, Midrex utilized a NAICS code of "541330." Midrex assigned itself the NAICS code 541330 after reviewing the NAICS manual and taking into consideration its business activities, including the field services it provides pursuant to the Plant Sale Contracts. Midrex continues to utilize the "541330" NAICS code on its State Tax Returns filed with the Department since the Period at Issue. NAICS code 541330 does not fall within the construction sector of NAICS.

34. In a Stipulation dated 7 March 2014, the parties stipulated that, if Petitioner was an excluded corporation during the Period at Issue, Petitioner would be entitled to a refund of State corporate income and franchise taxes in the amount of \$3,303,736. The parties further stipulated that, if Petitioner was not an excluded corporation, Petitioner would not be entitled to any refund of State corporate income and franchise taxes for the Period at Issue.

CONCLUSIONS OF LAW

1. A petitioner in an administrative contested case proceeding bears the burden of proving its entitlement to relief from an agency's decision. *See Holly Ridge Assocs., LLC v. N.C. Dep't of Env't & Natural Res.*, 361 N.C. 531, 648 S.E.2d 830 (2007) (recognizing that a "petitioner had the burden of proof in OAH contested cases").

2. In contested tax cases involving the Department's denial of a State tax refund claim, a petitioner satisfies its burden in the OAH by alleging sufficient facts to demonstrate the invalidity of the tax and its entitlement to a refund. *See Railway Express Agency, Inc. v. Maxwell*, 199 N.C. 637, 642, 155 S.E. 553, 555 (1930) ("the burden is on him who seeks the recovery of a tax already paid to establish those facts which show its invalidity") (*quoting Compania General v. Collector*, 279 U.S. 306, 310 (1929)).

3. Pursuant to N.C. Gen. Stat. § 150B-34, the Court is required to issue a "final decision or order" deciding the contested case. In doing so, the Court is authorized "to grant summary judgment . . . that disposes of all issues in the contested case." N.C. Gen. Stat. § 150B-34(e).

4. "Summary judgment is properly granted if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that any party is entitled to a judgment as a matter of law." *Delhaize Am., Inc. v. Lay*, ___ N.C. App. ___, ___, 731 S.E.2d 486, 490 (2012).

5. Corporations doing business in North Carolina are subject to the franchise and corporate income taxes imposed under Articles 3 and 4, respectively, of the North Carolina Revenue Act ("Act"), N.C. Gen. Stat. § 105-1, *et. seq.* While State franchise taxes are measured by "the total amount of [a corporation's] issued and outstanding capital stock, surplus and undivided profits (collectively "Capital Stock Base"), N.C. Gen. Stat. § 105-122(b), the State corporate income tax is levied on the State net income of a C-corporation. N.C. Gen. Stat. § 105-130.3. A corporation that has income from sources both within and outside the State must allocate and

apportion its Capital Stock Base and State net income in accordance with the provisions of the N.C. Gen. Stat. §§ 105-122(c1)(1) and 105-130.4.

6. The standard apportionment formula is set forth in N.C. Gen. Stat. §105-130.4(i), and requires, in part, corporations *other than excluded corporations* to apportion its net income by utilizing an apportionment formula consisting of the following factors: property, payroll and sales (collectively “Standard Three-Factor Apportionment Formula”).

7. The apportionment provision for excluded corporations is set forth in N.C. Gen. Stat. §105-130.4(r). Unlike the Standard-Three Factor Apportionment Formula, the apportionment formula for an excluded corporation consists of *only* one factor, sales (“Single-Factor Apportionment Formula”). See N.C. Gen. Stat. §105-130.4(r).

8. Under the Act, an excluded corporation is:

[A]ny corporation *engaged in business as a building or construction contractor*, a securities dealer, or a loan company or a corporation that receives more than fifty percent (50%) of its ordinary gross income from intangible property.

N.C. Gen. Stat. §105-130.4(a)(4) (emphasis added).

9. “It is the duty of the Secretary [of Revenue] to interpret all laws administered by the Secretary. N.C. Gen. Stat. § 105-264. Interpretation of these laws shall be consistent with the applicable rules and is prima facie correct. *Id.* Furthermore, these laws are interpreted by publishing a bulletin. Taxpayers are entitled to rely upon the interpretation. The Secretary of Revenue published the following during the Period at Issue: Franchise Tax, Corporate Income Tax, Privilege Tax, Insurance Premium Tax and Excise Tax Rules and Bulletins Taxable Years 2005 & 2006 and 2007 & 2008 (collectively “Bulletins”).

10. In the Bulletins, Respondent interpreted the phrase “building or construction contractor” for purposes of N.C. Gen. Stat. § 105-130.4(a)(4) as follows:

A building or construction contractor is a business so classified in the North American Industry Classification System (NAICS) published by the Federal Office of Management and Budget.

11. Promulgated by the U.S. Office of Management and Budget, NAICS is a self-identification industry classification system that groups establishments into industries based on the similarities of their production process. As recognized by the North Carolina Court of Appeals, NAICS classifications are based on *primary business activity*:

12. In recognition of the fact that many business entities are engaged in multiple activities, the NAICS guidelines provide that an establishment is classified to an industry when its *primary*

activity meets the definition for that industry. *N.C. Dep't of Revenue v. Bill Davis Racing*, 201 N.C. App. 35, 50, 684 S.E.2d 914, 925 (2009).

13. A business entity's "primary activity" is signified by the "principal product or group of products produced or distributed, or services rendered," which in turn is determined by looking at factors such as capital investments, revenue, and employment. *Id.* at 51, 684 S.E.2d at 925.

14. Sector 23 of NAICS, entitled "Construction", is comprised of "*establishments primarily engaged in the construction of buildings or engineering projects (e.g., highways and utility systems).*" *Appendix*, Tab 14, p. 169 (emphasis added). Thus, the "[a]ctivities of this sector are erecting buildings and other structures (including additions); heavy construction other than buildings; and alterations, reconstruction, *installation*, and maintenance and repairs." *Id.* at 17 (emphasis added). In determining whether business activities are those that fall within the NAICS construction sector, contracts play a critical role as NAICS specifically notes that "[p]roduction responsibilities for establishments in [Sector 23] are usually specified in (1) contracts with the owners of construction projects (prime contracts) or (2) contracts with other construction establishments (subcontracts)." *Id.* at 169.

15. Pursuant to N.C. Gen. Stat. 105-130.4(a)(4), an excluded corporation includes a corporation "engaged in business as a building or construction contractor." The use of the phrase "engaged in business" contemplates a determination of a corporation's primary business activity. *See State Farm Mut. Auto. Ins. Co. v. Seeba*, 433 S.E.2d 414, 416 (Ga. Ct. App. July 6, 1993) (internal citations and quotations omitted) (recognizing that the "general rule of law [is] that the words 'engage in business' imply an element of continuity or habitual practice[.]" and, that ordinarily "the word 'business' is that which occupies the time, attention and labor . . . for the purpose of livelihood or profit."); *PIC Oil Co. v. Grisham*, 702 P.2d 28, 30 (Okla. April 30, 1985) (citing the corporation's *primary business* when determining whether it was "engaged in the business" of a particular industry for purposes of a statute).

16. Consistent with N.C. Gen. Stat. § 105-130.4(a)(4), Respondent's interpretation utilizes NAICS, a classification system based on primary business, for purposes of determining whether a corporation is a building or construction contractor. *See Bulletins*. When addressing issues of statutory construction, as required in this contested case, Respondent's interpretation contained in the Bulletin is "strongly persuasive." *Polaroid v. Offerman*, 349 N.C. 290, 301, 507 S.E.2d 284, 293 (1998).

17. The North Carolina Supreme Court has recognized that "[t]he construction adopted by the administrators who execute and administer a law in question is one consideration where an issue of statutory construction arises." *Id.* By law, such constructions are presumed to be "prima facie correct." N.C. Gen. Stat. § 105-264. In this case, the presumption of correction of Respondent's interpretation of N.C. Gen. Stat. § 105-130.4(a)(4) is even stronger given the General Assembly's failure to amend the statute in light of Respondent's long-standing interpretation, which it became fully aware of in December 2013.

18. Because the “legislature is always presumed to act with full knowledge of prior and existing law,” and has made no revisions to the statutory language of N.C. Gen. Stat. §§ 105-130.4(a)(4), it is proper for the Court “to assume that it is satisfied with the interpretation” of N.C. Gen. Stat. § 105-130.4(a)(4) reflected in Respondent’s Bulletins. *Polaroid*, 349 N.C. at 303, 507 S.E.2d at 294.

19. Applying NAICS, the undersigned concludes that Midrex’s business activities, primary or otherwise, do not fall within the NAICS construction sector and Midrex was therefore not engaged in business as a building or construction contractor within the meaning of N.C. Gen. Stat. § 105-130.4(a)(4) during the Period at Issue.

20. “Building or construction contractor” is not defined in the Act. “Undefined words are accorded their plain meaning so long as it is reasonable to do so” *Polaroid*, 349 N.C. at 297, 507 S.E.2d at 290. Applying the natural and ordinary meaning of “building or construction contractor”, the undersigned reaches a similar conclusion regarding Midrex’s failure to be engaged in business as a building or construction contractor within the meaning of N.C. Gen. Stat. § 105-130.4(a)(4) during the Period at Issue even without giving consideration to Respondent’s interpretation utilizing NAICS.

DECISION

For the foregoing reasons, the undersigned concludes Petitioner is not entitled to any refund of State corporate income and franchise taxes during the Period at Issue as it was not engaged in business as a building or construction contractor and is therefore not entitled to utilize the single-factor apportionment methodology for excluded corporations set forth in N.C. Gen. Stat. § 105-130.4(r). Accordingly, the undersigned GRANTS the Motion for Summary Judgment filed by Respondent and DENIES the Motion for Summary Judgment filed by Petitioner.

NOTICE

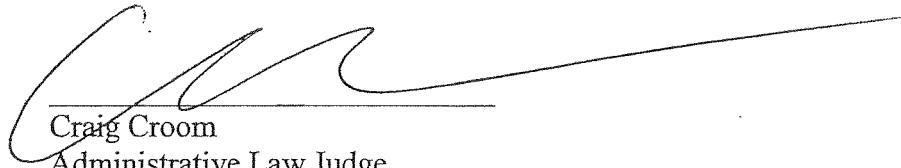
This is a Final Decision issued under the authority of N.C. Gen. Stat. § 150B-34.

Under the provisions of North Carolina General Statute § 150B-45, any party wishing to appeal the final decision of the Administrative Law Judge must file a Petition for Judicial Review in the Superior Court of Wake County. **The appealing party must file the petition within 30 days after being served with a written copy of the Administrative Law Judge’s Final Decision.** In conformity with the Office of Administrative Hearings’ rule, 26 N.C. Admin. Code 03.0102, and the Rules of Civil Procedure, N.C. General Statute 1A-1, Article 2, **this Final Decision was served on the parties the date it was placed in the mail as indicated by the date on the Certificate of Service attached to this Final Decision.** N.C. Gen. Stat. § 150B-46 describes the contents of the Petition and requires service of the Petition on all parties. Under N.C. Gen. Stat. § 150B-47, the Office of Administrative Hearings is required to file the official

record in the contested case with the Clerk of Superior Court within 30 days of receipt of the Petition for Judicial Review. Consequently, a copy of the Petition for Judicial Review must be sent to the Office of Administrative Hearings at the time the appeal is initiated in order to ensure the timely filing of the record.

IT IS SO ORDERED.

This the 10th day of October, 2014.



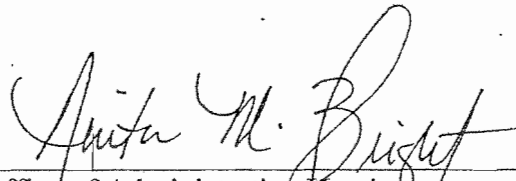
Craig Croom
Administrative Law Judge

On this date mailed to:

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This the 10th day of October, 2014.



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