STATE OF NORTH CAROLINA	**BEFORE THE NORTH CAROLINA DEPARTMENT OF REVENUE**
COUNTY OF WAKE	**09 REV 05695**
GENERAL DYNAMICS ARMAMENT AND TECHNICAL PRODUCTS, INC.,))) **Petitioner,**)) **v.**)) **N.C. DEPARTMENT OF REVENUE,**)) **Respondent.**))	**FINAL AGENCY DECISION**

THIS MATTER concerning General Dynamics Armament and Technical Products, Inc. ("GDATP") v. N.C. Department of Revenue ("Department" or "Respondent") came before the Department from the Decision ("ALJ Decision") of the Honorable Joe L Webster, Administrative Law Judge ("ALJ"), filed in the Office of Administrative Hearings ("OAH") on May 25, 2011. The official administrative record was transmitted by the OAH to the Department on July 7, 2011. By letter dated July 7, 2011, each party was notified of the opportunity to file exceptions to the ALJ's Decision as well as file a supporting brief and proposed final order. After a full review of the entire record of this matter, including the official record as defined in N.C. Gen. Stat. § 150B-37(a), and upon consideration of the briefs and other documents filed or submitted by the respective parties, the Department makes the Final Agency Decision.

Deletions from the ALJ Decision are marked with ~~strikethroughs~~ and additions/modifications are in **bold**.

Respondent requested that the name of Andrew O. Furuseth, Assistant Attorney General, be added to that of David D. Lennon as counsel for Respondent, and the "Appearances" portion of the ALJ Decision is hereby adopted with that addition.

APPEARANCES

For Petitioner:

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For Respondent:

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The Department adopts the "Applicable Law" portion of the ALJ Decision.

APPLICABLE LAW

The statutory law applicable to this contested case is N.C. Gen. Stat. Chapter 150B, Article 3, the North Carolina Administrative Procedure Act, and N.C. Gen. Stat. Chapter 105, Article 5, the North Carolina Sales and Use Tax Law.

Respondent takes exception and objects to the Issue stated in the ALJ Decision because it frames the purchase of the "indirect" or "non-component" property ("Disputed Property") as being "pursuant to contracts containing Federal Acquisition Regulations (FARs) provisions." However, ¶ 11 of the Joint Stipulations of Fact agreed to by the parties provides that the amount of sales and use tax in dispute was ascertained by determining "the percentage of Disputed Property purchased by GDATP under government contracts containing FAR title-passage provisions as agreed upon by the Department and GDATP following a review of the relevant Contracts." The Department rejects the issue as stated in the ALJ Decision and adopts a new issue as below stated.

ISSUE

~~Whether Respondent deprived Petitioner of property or substantially prejudiced the Petitioner's rights and exceeded its authority or jurisdiction; acted erroneously; failed to use proper procedure; acted arbitrarily or capriciously; or failed to act as required by law or rule by assessing use taxes upon Petitioner in the purchase of "indirect" or "non-component" property ("disputed property") pursuant to contracts containing Federal Acquisition Regulations (FARS) provisions?~~

Whether Petitioner's purchase of Disputed Property to which title is transferred to the U.S. Government pursuant to the terms of contracts containing Federal Acquisition Regulations (FARs) title passage provisions is a sale for resale in the regular course of business which rebuts the presumptions that use tax is due and that the use tax assessment is correct.

Except for modification as the result of scrivener's errors, the Department adopts the witness list and the list of Exhibits admitted into evidence as set forth in the ALJ Decision.

WITNESSES

At the hearing, the following witness testimony was received:

Witness	***Affiliation***	***Pages***
Matthew J. Canavan	GDATP	28-79
Richard C. Stewart	~~(~~Department **of Revenue** ~~DOR)~~ **(**GDATP's Adverse Witness)	80-171; 175-177

EXHIBITS ADMITTED INTO EVIDENCE

The following exhibits from GDATP were admitted into evidence:

Exhibit No.	***Description***
16	October 1, 2008 letter from Warren Kean to Richard Stewart with attachments 1-3
21	September 4, 2009 Notice of Final Determination from the DOR to **GD**ATP
24	Excerpts from the 2004 North Carolina Sales and Use Tax Laws
25	Excerpts from Chapter 7 of the North Carolina Administrative Code
28	November 13, 2006 email from Freddy Faircloth to Cynthia Camp attaching an excerpt from a~~n~~ **GD**ATP contract with the U.S. Army
40	Opinion from *In the Matter of: The Proposed Assessment of Additional Sales and Use Tax for the Period March 1, 1999 through December 31, 2001, by the Secretary of Revenue of North Carolina v. [name of taxpayer is redacted]* (Jan. 9, 2004) ("Final Decision Doc. No. 2003-317")

FINDINGS OF FACT

BASED UPON careful consideration of the sworn testimony of the witnesses presented at the hearing, the documents and exhibits received and admitted into evidence, and the entire record in this proceeding, the Undersigned makes the following Findings of Fact. In making the Findings of Fact, the Undersigned has weighed all of the evidence and has assessed the credibility of the witnesses by taking into account the appropriate factors for judging credibility, including but not limited to, the demeanor of the witness, any interests, bias, or prejudice the witness may have, the opportunity of the witness to see, hear, know, or remember the facts or occurrences about which the witness testified, whether the testimony of the witness is reasonable, and whether the testimony is consistent with all other creditable evidence in the case.

Joint Stipulated Facts (Paragraphs 1-11)

Findings of Fact numbers 1 through 4 of the ALJ Decision correspond to the "Joint Stipulations of Fact" of the parties and are adopted by the Department.

1. GDATP is a manufacturer of products for governmental and commercial use.

2. GDATP has maintained its office headquarters and a manufacturing facility in Charlotte, North Carolina since 2003.

3. The Department conducted a Sales and Use Tax audit of GDATP for the period October 1, 2003 through July 31, 2005 ("Audit Period").

4. During the Audit Period, GDATP's manufacturing facility in Charlotte constructed, *inter alia*, advanced biological and chemical agent detection systems ("sensors") for the United States government and agencies thereof, namely the U.S. Army ("government" or "customer"), pursuant to various contracts ("Contracts").

The footnote to Finding of Fact number 5 was not contained in the "Joint Stipulations of Fact," and said footnote consists of legal conclusions not stipulated to by the parties. Accordingly, the footnote to Finding of Fact number 5 is rejected, and the main body of Finding of Fact number 5 is adopted by the Department.

5. From that audit, the Department made sales and use tax assessments against GDATP for certain items of property. GDATP refers to this property as indirect-charge property while the Department calls it noncomponent property. Hereinafter, the property at issue in this case shall simply be referred to as the "Disputed Property."[1]

At the hearing, Finding of Fact number 6 was amended by the parties. Therefore, Finding of Fact number 6 as written in the ALJ Decision which reflects the wording of ¶ 6 of the "Joint Stipulations of Fact" prior to its amendment at the hearing is rejected. The language of Finding of Fact number 6 is hereby revised and adopted to reflect the Joint Stipulations of Fact number 6 as amended by the parties at the hearing. Tr. at 37. *See also* Tr. Pp 5-9.

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[1] ~~Though the Notice of Final Determination refers to the types of property as "component" and "noncomponent," the Undersigned finds that the property is referred to in the industry as "direct charge" and "indirect charge," respectively. (Tr. at 36-37). Most fundamentally, however, attempting to distinguish between "component" and "noncomponent" property is irrelevant to the issue to be decided given that the DOR concedes the indirect-charge property at issue is indeed sold to the Government. (Tr. at 99, 136). Additionally, as noted in Findings of Fact ¶ 48, *infra*, any distinction between "component" and "noncomponent" property is not viewed as relevant in (1) the two private letter rulings attached by the DOR to the Notice of Final Determination, (2) the regulations set forth at 17 N.C.A.C. 07B .3503-.3505, (3) Final Decision Doc. No. 2003-317, or (4) Technical Bulletin 5-2(A). Further, North Carolina courts have held a reseller's purchase and use and storage of noncomponent property, like the indirect-charge property in this case, to not be subject to use taxes: *see, e.g., Appeal of Clayton Marcus Co., Inc.*, 286 N.C. 215, 210 S.E.2d 199 (1974) (holding fabric used in swatch books, which was not incorporated or made into a component part of the manufactured furniture, was not subject to use taxes) and *In the Matter of Rock-Ola Café*, 111 N.C. App. 683, 433 S.E.2d 236 (1993) (holding bar "munchies," which were not component parts of the restaurant's menu items sold to the restaurant's customers, were not subject to use taxes).~~

6. The Contracts contain certain provisions of the Federal Acquisition Regulations (FARs) which provide that the title to the Disputed Property purchased by GDATP is transferred to the **G**overnment upon ~~its purchase by the GDATP~~ **the terms specified in the FAR provisions attached to the "Joint Stipulations of Fact" as Exhibit A and Exhibit B respectively**. (**Tr. at 37).**

Findings of Fact numbers 7 and 8 are modified for clarity and are adopted by the Department as modified.

7. The text of the FAR title-passage provision for "cost plus" contracts is set forth in FAR § 52.245-5(c) which is included in Exhibit A attached ~~hereto~~ **to the "Joint Stipulations of Fact"**. Subsection (c)(2) pertains to "direct-charge" property and subsection (c)(3) pertains to the disputed property.

8. The text of the FAR title-passage provision for "fixed price with progress payments" contracts is set forth in FAR § 52.232-16(d), attached ~~hereto~~ **to the "Joint Stipulations of Fact"** as Exhibit B.

Except for a modification as the result of a scrivener's error, the Department adopts Finding of Fact number 9.

9. Pursuant to the Contracts, GDATP purchased tangible personal property, including both direct-charge property and Disputed **P**~~p~~roperty. Direct-charge property means property GDATP accounts for as direct charges against the contract. These typically include materials incorporated in an end product. Disputed Property means property that is purchased by GDATP and accounted for in overhead for which title is transferred under the provisions referenced in either paragraphs 7 or 8, above.

Findings of Fact numbers 10 through 14 are adopted by the Department.

10. The Disputed Property items were not incorporated into the sensors and other property GDATP manufactured for its customer.

11. The parties agree that the amount of sales and use tax in dispute with respect to the Disputed Property at issue is $21,019.58, plus interest. This amount is derived by multiplying the amount of sales and use taxes that the Department determined was owed by GDATP with respect to the Audit Period for Disputed Property ($23,822.13) by 88.2355% (the percentage of Disputed Property purchased by GDATP under government contracts containing FAR title-passage provisions as agreed upon by the Department and GDATP following a review of the relevant Contracts).

12. GDATP is a government contractor located in Charlotte, Mecklenburg County that provides, among other products, chemical and biological detection systems to the United States Government, primarily the U.S. Army. (Tr. at 30-32).

13. The N.C. Department of Revenue (hereinafter Department) is the State Agency responsible for the administration of North Carolina's Sales and Use Tax Law, N.C. Gen. Stat. Chapter 105, Article 5.

14. The parties received proper notice of the hearing.

The Respondent takes exception to the inclusion of the second sentence in Finding of Fact number 15 and states it is not supported by the evidence in the record. The Respondent does not dispute that the contracts at issue in this case did contain FARs title-transfer provisions. Therefore, Finding of Fact number 15 is modified for clarity and adopted by the Department.

15. GDATP obtains business by bidding on and winning contracts with the Government. **The contracts at issue in this case contain certain provisions of the Federal Acquisition Regulations (FARs) which provide that the title to the Disputed Property purchased by GDATP is transferred to the Government upon the terms specified in the FAR provisions attached to the "Joint Stipulations of Fact" as Exhibit A and Exhibit B respectively**. (**Stipulation 6, as amended; Tr. at 37).** The terms of ~~those~~ **these** Contracts are virtually all mandated by the Government and come from the FAR. The Contracts incorporate by reference specific provisions of the FAR as if those provisions were inserted into the contracts word for word. (Tr. at 32-35).

Finding of Fact number 16 is adopted by the Department.

16. Among the FAR provisions incorporated into GDATP's Contracts that relate to the property at dispute in this matter are the title passage provisions for "cost-plus" contracts (FAR § 52.245-5(c)) and "fixed price with progress payments" contracts (FAR § 52.232-16(d)). (Stipulations 6-8).

The Respondent takes exception to the inclusion of the last sentence of Finding of Fact number 17 and states it is not supported by the evidence in the record. Therefore, Finding of Fact number 17 is modified for clarity and adopted by the Department.

17. Pursuant to these title passage provisions, title to both direct-charge and indirect-charge property (referred to herein as disputed property) is transferred on a regular, recurring, and routine basis from GDATP to the Government. (Tr. at 38-41). The title passage provisions of the FAR also provide that title to the disputed property reverts to the Petitioner at the completion of the contract. This reversion is done at zero value for bookkeeping purposes. **(Tr. at 66-67).** At the end of the contract Petitioner is free to use the disputed property in any manner it chooses, including selling it to third parties. **If the left over disputed property were sold, GDATP would provide a credit and give the overhead rate and the Government the benefit of that credit. (Tr. at 68, 73).** However, if the disputed property is not completely used up in fulfilling an existing contract, it is **often** used in future contracts with the federal government. **(Tr. at 68, 73).**

The Respondent takes exception to Finding of Fact number 18 and states it is not supported by the evidence in the record. The Respondent does not dispute that the

contracts at issue in this case did contain FARs title-transfer provisions. Therefore, Finding of Fact number 18 is modified for clarity and adopted by the Department.

18. **The contracts at issue in this case contain certain provisions of the Federal Acquisition Regulations (FARs) which provide that the title to the Disputed Property purchased by GDATP is transferred to the Government upon the terms specified in the FAR provisions attached to the "Joint Stipulations of Fact" as Exhibit A and Exhibit B respectively**. (**Stipulation 6, as amended; Tr. at 37).** GDATP is required to transfer title to all property purchased pursuant to Contracts with these FAR provisions. Thus, at the time of GDATP's purchase of the direct-charge and disputed property, GDATP is contractually obligated to resell the property to the Government. (Tr. at 54).

Findings of Fact numbers 19 and 20 are adopted by the Department.

19. Title to the direct-charge property is transferred to the federal government when it is charged to a particular contract. (Tr. at 47-48).

20. Title to the disputed property is transferred to the federal government once the overhead costs are allocated by GDATP to its various Contracts. GDATP purchases disputed property almost daily and then allocates those costs to GDATP's overhead accounts on the second business day following the week in which the property was purchased. Then, on the second business day following the end of each month, those overhead accounts are allocated to GDATP's Contracts, thereby transferring title (i.e., selling) to the disputed property from GDATP to the Government. (Tr. at 48-50, 75-76).

The Respondent takes exception to Finding of Fact number 21's use of the word "tooling" instead of the word "tools" and indicates that listing "tooling" as an overhead item is not supported by the evidence in the record. Therefore, Finding of Fact number 21 is modified for clarity and adopted by the Department.

21. The categories of disputed property that comprise the overhead rate charged by GDATP include, but are not limited to, shop supplies, office supplies, and tool~~ings~~**s. (Tr. at 46, 66-67).** Much of the disputed property is property which is used in the manufacturing process such as Kimwipes, which are a lead free cloth that is used to wipe down equipment to remove dust particles and maintain an ultra-clean environment. (Tr. at 43-46). Such items are transferred to the federal government and the Petitioner retains possession of the items at all times.

Findings of Fact numbers 22 through 25 are adopted by the Department.

22. The sum of the dollar amounts in the categories of disputed property is divided by the projected direct labor costs to arrive at the overhead rate. (Tr. at 46-47).

23. The overhead rate charged by GDATP to the Government is negotiated by GDATP and the Government, and set forth in a Forward Pricing Agreement. (Tr. at 44, 47).

24. The overhead rate is multiplied by a Contract's direct labor costs to determine the amount of overhead cost to be allocated to that Contract. GDATP then applies a general and administrative overhead (G&A) percentage to that overhead cost, to which a profit margin is

then added to calculate the sales price of the indirect-charge property to the Government. (Tr. at 47-49). Accordingly, GDATP's charges to the Government for the disputed property were separate from its charges for the direct-charge property, and GDATP accounts for the disputed property as the equivalent of inventory upon purchase and the equivalent of cost of goods sold upon resale to the Government. (Tr. at 77-78).

25. The sales price paid by the Government for the disputed property is always higher than the price paid for that property by GDATP. (Tr. at 49-50).

The Respondent takes exception to Finding of Fact number 26 and states it is not supported by the evidence in the record. The Respondent does not dispute that the contracts at issue in this case did contain FARs title-transfer provisions. Therefore, Finding of Fact number 26 is modified for clarity and adopted by the Department.

26. **The contracts at issue in this case contain certain provisions of the Federal Acquisition Regulations (FARs) which provide that the title to the Disputed Property purchased by GDATP is transferred to the Government upon the terms specified in the FAR provisions attached to the "Joint Stipulations of Fact" as Exhibit A and Exhibit B respectively**. (**Stipulation 6, as amended; Tr. at 37).** When GDATP purchases an item of disputed property, it does so knowing that it is obligated to resell that property to the Government pursuant to its Contracts. GDATP would not purchase the disputed property without having the Contracts in place. (Tr. at 50, 53-54).

Finding of Fact number 27 is rejected by the Department as it is a conclusion of law rather than a finding of fact.

27. ~~Having purchased the disputed property for resale, GDATP must normally pay sales taxes on the *resales* with funds collected from its customer for that purpose, except in those cases in which its customer is the Government or is otherwise exempt or immune from tax.~~

Respondent takes exception to the characterization of the transfer of title to the Government as a "resale" in Finding of Fact number 28 as being a conclusion rather than a finding of fact. The Department modifies the first sentence for clarity. The last sentence of Finding of Fact number 28 is a conclusion of law rather than a finding of fact and is rejected. As edited, modified Finding of Fact number 28 is adopted by the Department.

28. GDATP's purchase and **subsequent** ~~re~~sale of disputed property occurs at least daily and monthly, respectively. ~~Therefore, those transactions are routine, recurring, and undertaken in the regular course of its business.~~ (Tr. at 50, 55-56).

The wording of Finding of Fact number 29 is ambiguous in its placement of the pronoun "it" in the first sentence. Therefore, the Department has rewritten the first sentence and made two sentences to clarify that the pronoun "it" refers to GDATP. Footnote number 2 contained in Finding of Fact number 29 refers to the holdings of cases cited therein and does not provide factual information relevant to this matter. Accordingly, Footnote number 2 is rejected and stricken from Finding of Fact number 29. Finding of Fact number 29 as modified is adopted by the Department.

29. The Government owns the disputed property once title is transferred from GDATP~~,~~. **GDATP** ~~it~~ retains possession of the disputed property to fulfill its Contracts. The Government, however, maintains a right of possession to the disputed property. (Tr. at 58-60). [2]

Respondent takes exception to the portion of Finding of Fact number 30 which indicates that the "benefits and burdens of ownership" are assumed by the Government and the timing thereof as being unsupported by the evidence. The Department rejects this finding of fact as written and modifies the last section of Finding of Fact number 30 to reflect when title to the Disputed Property is transferred to the Government. Modified Finding of Fact number 30 is adopted by the Department.

30. GDATP's "storage" and "use" of the disputed property to carry out its Contracts with the Government occurs after GDATP is contractually obligated to sell the property to the Government**.** ~~, with the benefits and burdens of ownership of the property being assumed by the Government from the moment GDATP purchases the property followed shortly thereafter by the formal transfer of title to the property from GDATP to the Government once the accounting has been completed.~~ **Title to the Disputed Property purchased by GDATP is transferred to the Government upon the terms specified in the FAR provisions attached to the "Joint Stipulations of Fact" as Exhibit A and Exhibit B respectively**. (**Stipulation 6, as amended; Tr. at 37).**

Finding of Fact number 31 as written by the ALJ refers to a statute which was not in existence during the audit period and is a conclusion of law. The Department hereby rejects Finding of Fact number 31.

31. ~~GDATP's "business," as defined in N.C. Gen. Stat. § 105-164.3(1k), and which term of art is to be used in determining those transactions that comprise GDATP's "regular course of business," therefore includes not only the delivery of the end product called for under the Contracts, but also the mandatory purchase and resale of direct charge and disputed property pursuant to the terms of those Contracts. (Tr. at 55-57, 64).~~

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[2] ~~*Lockheed Aircraft Corp. v. State Bd. Of Equalization*, 81 Cal. App. 3d 257, 267 (Cal. Ct. App. 1978):~~

> ~~The federal government was entitled to remove the [special test] equipment [and tools] at any time during the contract, and after completion of the contract the federal government could direct its further use or sale. The federal government of course did not exercise its option to remove the equipment during the contracts since that would have frustrated the contractual purposes.~~

~~*See also Northrop Grumman Corp. v. County of Los Angeles*, 134 Cal. App. 4th 424, 432 (Cal. Ct. App. 2005), *cert. denied* 1275 S.Ct. 79 (2006) ("Under [FAR] title-vesting provisions in a progress payments contract, the federal government is entitled to *immediate possession* of materials used by a defaulting contractor which produced meals ready to eat for the military.") (Emphasis added).~~

Except for a modification as the result of a scrivener's error, the Department adopts Finding of Fact number 32.

32. From the audit referenced in ¶ 3, the Department issued a Notice of Final Determination on September 4, 2009 that made use tax assessments against GDATP for certain items of property. (**GD**ATP's Exhibit 21).

Finding of Fact number 33 is adopted by the Department.

33. The total amount of taxes and interest assessed by the Notice of Final Determination was $218,641.71. Of that amount, GDATP challenges only $21,019.58 in taxes plus interest. (GDATP's Exhibit 21).

Finding of Fact number 34 is amended for clarity and adopted by the Department.

34. The Department also imposed penalties in the amount of $74,550.47. **The penalties were assessed for failure to file tax returns and understatement of taxes by 25% or more.** (GDATP's Exhibit 21). GDATP has filed Form NC-5500 requesting that this penalty be waived under the Department's Penalty Waiver Policy. (Petition for Contested Case Hearing).

Finding of Fact number 35 is adopted by the Department.

35. The Department agreed that GDATP's purchases of direct-charge property were for resale in the regular course of business and, therefore, not subject to use tax. (GDATP's Exhibit 21).

Respondent takes exception to Finding of Fact number 36 as an over-simplification of Respondent's Notice of Final Determination and cites N.C. Gen. Stat. § 105-241.14(b)(1) (2007) as statutory authority for changing its basis for the issuance of the Notice of Final Determination. The Department rejects Finding of Fact number 36 as originally written and hereby modifies Finding of Fact number 36 by clarifying the substance of the Notice of Final Determination and correcting a scrivener's error. Modified Finding of Fact number 36 is adopted by the Department.

36. The Department, however, determined **in its Final Determination** that GDATP is subject to use tax on the ~~department~~ **disputed** property resold by GDATP to the Government because such resales were not "in the regular course of business," as required by N.C. Gen. Stat. §§~~ 105-164.6, 105-164.3(44), and~~ 105-164.3(49) **and GDATP did not rebut the presumption under N.C. Gen. Stat. § 105-164.26 that either a sales or use tax applies to a sale**. (GDATP's Exhibit 21).

Finding of Fact number 37 presents a one-sided view of the requirement of N.C. Gen. Stat. § 105-241.14(b)(1). The Department rejects Finding of Fact number 37 as originally written and modifies same for clarification. Modified Finding of Fact number 37 is adopted by the Department.

37. N.C. Gen. Stat. § 105-241.14(b)(1) requires the Department to state in the Notice of Final Determination "the basis for the determination." The Notice of Final Determination, however, does not cite any case law, Technical Bulletin, or Administrative Code provision in support of the DOR's decision. **Respondent did cite statutes in supports of its Notice of Final Determination. This same statute expressly permits Respondent to change the basis of its determination. N.C. Gen. Stat. § 105-241.14(b)(1) (2007).**

Except for a modification as the result of a scrivener's error, the Department adopts Finding of Fact number 38.

38. The Notice of Final Determination, at the end of the "Determination" section, states the following bases for the DOR's determination (Tr. at 124-125):

> As evidenced by the two attached private letter rulings, for over twenty years the Department's administrative practice has been to permit the purchase of component property, title to which passes to the federal government, to be treated as sales for resale, but to require payment of use tax on the purchase of non-component property notwithstanding that the cost of the non-component property is reimbursed to the purchaser.
>
> This practice is consistent with the statutes cited above and the Department's position in this case that the non-component property is not the type of property *generally and ordinarily sold by GDATP in its regular course of business*.

(**GD**ATP's Exhibit 21) (emphasis added).

Respondent takes exception to Finding of Fact number 39 by indicating it is a conclusion of law and that private letter rulings are not statements of the Respondent's position. However, the two private letter rulings were attached to the Notice of Final Determination and referenced as being indicative of Respondent's position in this matter. The Department rejects the portion of Finding of Fact number 39 which is a conclusion of law and modifies the remainder of this finding of fact. Modified Finding of Fact number 39 is adopted by the Department.

39. ~~The first paragraph quoted in ¶ 38, however, is factually inaccurate, as the two private letter rulings hold just the opposite of that which is represented by the Department in the Notice of Final Determination.~~ Both private letter rulings, dated January 7, 1987 and June 28, 1996, make no reference to, or distinction between, "component" property and "noncomponent" property. ~~Further, the two rulings in fact establish that for over twenty years, the Department's administrative practice in cases such as this, for which property is sold to the Government (as contrasted from cases in which title to the subject property is not transferred but instead only the cost of the property is reimbursed by the Government), has been~~ not ~~to subject the government contractor's purchase and use of the disputed property to North Carolina use taxes. The letter rulings are clear in that regard:~~ **Both private letter rulings quote FAR § 52.245-5(c)(2) which is the title transfer passage for direct-charge or component property and FAR § 52.245-(c)(3) which is the title transfer passage for indirect-charge, non-component, or Disputed Property. The private letter rulings then go on to state:**

> It is our opinion that the purchase of tangible personal property [both direct-charge and indirect-charge] by contractors, title to which passes to [the Government] under the terms set forth above [FAR § 52.245-5(c)], constitutes purchases of tangible personal property by such contractors for the purpose of resale as such to [the Government].

(GDATP's Exhibit 21).

Finding of Fact number 40 is rejected by the Department as it is a conclusion of law rather than a finding of fact.

40. ~~The conclusions reached by the Department in the second paragraph quoted in ¶ 38, that the indirect-charge property in this case is not the "type of property generally and ordinarily sold by GDATP in its regular course of business" is not supported by a fair reading of the operative words "regular," "business," "course of business," and "regular course of business," particularly given the broad meaning that is required to be given to the term "business" as defined by N.C. Gen. Stat. § 105-164.3(1k). *See* Conclusions of Law at ¶¶ 7-11, *infra.*~~

Finding of Fact number 41 is adopted by the Department.

41. Richard C. Stewart was the administrative officer from the Department assigned to the GDATP audit and was therefore involved in the decision set forth in the Notice of Final Determination. (Tr. at 80-83).

Except for a modification as the result of a scrivener's error, the Department adopts Finding of Fact number 42.

42. Mr. Stewart has worked for the DOR for 28 years and has 24 years of experience with North Carolina's Sales and Use Tax Law. He testified that he considers himself to be as knowledgeable as anyone else at the Department with respect to the administration of North Carolina's Sales and Use Tax Law and the audit of **GD**ATP. (Tr. at 81-82).

Finding of Fact number 43 is adopted by the Department.

43. In its audit, the Department found that GDATP's "purchases of [direct-charge] property were for resale in the regular course of business to the [Government]." (GDATP's Exhibit 21).

Respondent takes exception to Finding of Fact number 44 as not being supported by the record and constituting a legal conclusion rather than a finding of fact. The Department adds references to sections of the hearing transcript and adopts Finding of Fact number 44.

44. Without performing any analysis of the phrase "regular course of business," or its operative words, the Department found that GDATP's purchases of disputed property were subject to use tax because that property was allegedly not resold to the Government in GDATP's "regular course of business." (GDATP's Exhibit 21). (**Tr. at 87, 132-133, 160).**

Finding of Fact number 45 is not supported by the record and is therefore rejected by the Department.

45. ~~GDATP, however, purchased and sold the disputed property with the same regularity and frequency as it purchased the direct-charge property.~~

Finding of Fact number 46 is adopted by the Department.

46. The Department was aware of Final Decision Doc. No. 2003-317 when it issued the Notice of Final Determination. (Tr. at 111-112).

Finding of Fact number 47 is not established in the record as the witness, Richard Stewart, indicated that he did not recall "reg .3505" being part of the analysis (Tr. at 135), that he was not the only one involved in issuing the Notice of Final Determination (Tr. at 83), and that he was not involved with all communications between the parties prior to the issuance of the Notice of Final Determination. (Tr. at 129). Finding of Fact number 47 is therefore rejected by the Department.

47. ~~The Department did not analyze 17 N.C.A.C. 07B .3505 in the preparation of the Notice of Final Determination. (Tr. at 135).~~

The Department adopts Finding of Fact number 48.

48. The private letter rulings attached by the Department to the Notice of Final Determination do not contain the words "component" or "noncomponent." (Tr. at 138, 142; GDATP's Exhibit 21). Likewise, 17 N.C.A.C. 07B .3503-.3505 and Final Decision Doc. No. 2003-317 do not contain the words "component" or "noncomponent."

Finding of Fact number 49 is not supported by the record, and it is irrelevant. Richard Stewart testified that he did not know all the documents or correspondence that were exchanged between the parties prior to the issuance of the Notice of Final Determination, and that he did not know whether the Respondent had provided a legal analysis of its position to Petitioner prior to the issuance of the Notice of Final Determination. (Tr. at 125-130). Whether a legal analysis was in fact provided to Petitioner by the Respondent is not relevant, because the Respondent was under no duty or legal requirement to provide such an analysis. *See* N.C. Gen. Stat. § 105-241.13. The Department rejects Finding of Fact number 49.

49. ~~Despite GDATP providing the Department with the legal analysis and case law supporting GDATP's position on multiple occasions over the course of the audit, the Department did not provide GDATP with any legal basis for the Department's position prior to the issuance of the Notice of Final Determination. (*Cf.* GDATP's Exhibit 16 with Tr. at 130).~~

Finding of Fact number 50 is unsupported by the record. The ALJ Decision cites pages 163-164 of the Transcript where Mr. Stewart testified that, while he did not personally consult an expert on the FARs, he does not know whether or not someone else in the Department did so. Mr. Stewart had testified earlier that he was not the person primarily responsible for the issuance of the Notice of Final Determination. (Tr. at 83). He

had further testified that he was not privy to all the correspondence that had occurred prior to the issuance of the Notice of Final Determination. (Tr. at 125-130). Accordingly, there is no evidentiary basis for a finding that the Respondent had or had not referred to a FARs expert. Moreover, this is irrelevant. The Department rejects Finding of Fact number 50.

50. ~~The Department did not consult with an expert in the FAR during the course of the GDATP audit and in connection with the Notice of Final Determination. (Tr. at 163-164).~~

Finding of Fact number 51 is adopted by the Department.

51. The Department acknowledges that the transfer of title to the disputed property from GDATP to the Government is a "sale" within the meaning of N.C. Gen. Stat. § 105-164.3(36). (Tr. at 99, 136).

Respondent takes exception to Finding of Fact number 52 as a mischaracterization of Mr. Stewart's testimony. Mr. Stewart testified that if the Disputed Property were sold to the Government, the Government would be a "purchaser." (Tr. at 99-100). However, it is unclear that the testimony was in reference to the specific facts of this case. In the two pages prior to the cited portion of the Transcript, Mr. Stewart testified that Petitioner was the purchaser of the Disputed Property for use tax purposes. (Tr. at 97-98). Mr. Stewart never stated that the Government was a purchaser for use tax purposes under N.C. Gen. Stat. § 105-164.6(b). (*See* Tr. at 97-100. 155-162). Finding of Fact number 52 as written is not supported by the record and is rejected by the Department.

52. ~~The Department acknowledges that the Government is the "purchaser" of the disputed property from GDATP within the meaning of N.C. Gen. Stat. § 105-164.3(32) and § 105-164.6(b). (Tr. at 99-100).~~

CONCLUSIONS OF LAW

The Department rejected findings of fact which were actually conclusions of law. Therefore, the first sentence of the preamble to the conclusions of law section is rejected.

~~To the extent that certain portions of the foregoing Findings of Fact constitute mixed issues of law and fact, such Findings of Fact shall be deemed incorporated herein as Conclusions of Law.~~ Based upon the foregoing Findings of Fact, the undersigned makes the following Conclusions of Law:

The Department adopts Conclusion of Law number 1.

1. The decision by the Undersigned, when determining whether the Department's Notice of Final Determination violated N.C. Gen. Stat. § 150B-23(a), is to be based upon the preponderance of the evidence. N.C. Gen. Stat. § 150B-34.

Prior to reaching a conclusion as set forth in Conclusion of Law number 2, the Department makes the following additional Conclusions of Law:

1(a). North Carolina's use tax applies to "tangible personal property purchased inside or outside this State for storage, use, or consumption in this State." N.C. Gen. Stat. § 105-164.6(a)(1) (2005).

1(b). The Disputed Property is tangible personal property. FOF 9, 21.

1(c). The definition of "storage" specifies that it means "any keeping or retention in this State for any purpose by the purchaser thereof, *except sale in the regular course of business,* of tangible personal property purchased from a retailer." N.C. Gen. Stat. § 105-164.3(44) (2005). (emphasis added).

1(d). The definition of "use" specifies that it means "the exercise of any right or power or dominion whatsoever over tangible personal property by a purchaser thereof and includes…any withdrawal from storage…by the owner or purchaser thereof, *but does not include the sale of tangible personal property in the regular course of business."* N. C. Gen. Stat. § 105-164.3(49) (2005). (emphasis added).

1(e). Petitioner must rebut the *prima facie* statutory presumption that the Disputed Property purchased by Petitioner and sold to the Government was subject to use tax. N.C. Gen. Stat. § 105-164.26 (2003).

1(f). Petitioner must rebut the statutory presumption that the Department's use tax assessment against Petitioner was correct. N.C. Gen. Stat. § 105-241.9(a) (2007).

1(g). Petitioner can rebut the two presumptions if it is able to show that its purchase of the Disputed Property was resold to the Government in the regular course of business.

1(h). The definition of "business" specifies that it "[i]ncludes any activity engaged in by any person or caused to be engaged in by him with the object of gain, profit, benefit or advantage, either direct or indirect." It does not include "occasional and isolated sales or transactions by a person who does not hold himself out as engaged in business." N.C. Gen. Stat. § 105-164.3 (2005).

1(i). Petitioner is engaged in business as a manufacturer of advanced biological and chemical agent detection systems for the United States Government pursuant to various contracts. FOF 4, 15, 16.

1(j). The parties stipulated that all of the contracts at issue in this case contain certain provisions of the FARs which provide that title to the Disputed Property purchased by Petitioner is transferred to the Government upon the terms specified in these provisions. Petitioner is <u>required</u> to transfer title to all personal property purchased pursuant to Contracts with these FAR provisions, it is not optional. Thus, at the time it purchases personal property subject to the FAR title transfer provisions, Petitioner is contractually obligated to resell the personal property to the Government. Title to direct-charge property is transferred when it is charged to a particular contract, while title to Disputed Property is transferred to the

Government once the overhead costs are allocated by Petitioner to its various Contracts. FOF 6, 7, 8, 9, 18, 19, 20, 26.

1(k). The Government pays to Petitioner a sales price for the Disputed Property which is always higher than the price paid by Petitioner for the items. FOF 25.

1(l). The Government "purchases" the Disputed Property from Petitioner in accordance with the statutory definition of "purchase" because the Disputed Property is "acquired for a consideration" and "the acquisition was effected by a transfer of title." N.C. Gen. Stat. § 105-164.3(32) (2005). The Department acknowledges that the transfer of title from Petitioner to the Government is a "sale" within the meaning of N.C. Gen. Stat. § 105-164.3(36). FOF 51. Therefore, Petitioner's purchases of Disputed Property are sales for resale. FOF 6, 7, 8, 9, 16,, 18, 19, 20, 25, 51.

1(m). The fact that Petitioner maintains possession of the Disputed Property during its contract with the Government is of no consequence since the statutory definition of "purchase" states that the acquisition may be "effected by a transfer of title or possession, or both." N.C. Gen. Stat. § 105-164.3(32) (2005).

1(n). The fact that title to the Disputed Property reverts to the Petitioner at the completion of the contract is of no consequence since the statutory definition of "purchase" states the transfer can be either "absolute or conditional." N.C. Gen. Stat. § 105-164.3(32) (2005).

1(o). Although the Department found that Petitioner's purchases of direct-charge property were made for resale in the regular course of business, the Department determined in its Notice of Final Determination that Petitioner owed use tax because its purchases of Disputed Property or "non-component property" were not made for resale in the regular course of business. The Notice stated that the "non-component property is not the type of property generally and ordinarily sold by GDATP in its regular course of business." In the body of the two redacted private letter rulings which were discussed in and attached to the Notice of Final Determination, the Department indicated that the purchase by contractors of non-component property, title to which passes to the Government under the terms of FAR § 52.245-5(c)(3), "constitutes purchases of tangible personal property by such contractors for the purpose of resale." FOF 32, 33, 35, 36, 38, 39, 44.

1(p). The North Carolina Administrative Code provides that "Sales of tangible personal property to contractors for use in performing contracts with the United States Government or its agencies and instrumentalities are subject to the applicable state and local sales or use tax." 17 N.C.A.C. 07B.4203. The rule does not discuss contracts whereby title passes to the Government pursuant to FARs title passage provisions.

1(q). Neither the North Carolina sales and use tax statutes nor 17 N.C.A.C. 07B .4203 mentions the terms "component" and "non-component." No evidence has

been presented which shows that "non-component property" cannot be sold in the regular course of business. Therefore, "non-component property" (the Disputed Property herein) may be sold in the regular course of business. FOF 48.

1(r). Petitioner's purchase of Disputed Property and the subsequent resale to the Government pursuant to the FARs title passage provisions occur at least daily and monthly, respectively. These transactions are a routine, recurring, and regular part of Petitioner's business, which includes both the delivery of the end product and the mandatory purchase and resale of Disputed Property pursuant to the Contracts containing FARs provisions. Therefore, Petitioner's purchases of Disputed Property were made for resale in the regular course of business. FOF 16, 17, 18, 20, 22, 23, 24, 25, 26, 28.

1(s). Since Petitioner's purchases of Disputed Property were made for resale in the regular course of business, these purchases are excluded from the statutes imposing use tax on Petitioner's "storage" and "use" of the Disputed Property. *See* N.C. Gen. Stat. §§ 105-164.3(44) and 105-164.3(49) (2005). Accordingly, Petitioner has rebutted the *prima facie* statutory presumption that the Disputed Property purchased by Petitioner and resold to the Government was subject to use tax as well as the statutory presumption that the Department's use tax assessment against Petitioner was correct. *See* N.C. Gen. Stat. §§ 105-164.26 (2003) and 105-241.9(a) (2007).

The Department adopts Conclusions of Law numbers 2 and 3.

2. As set forth in the above Findings of Fact, the Department violated the standards of N.C. Gen. Stat. § 150B-23(a) in determining that GDATP's resale of indirect-charge property to the Government was not "in the regular course of business."

3. N.C. Gen. Stat. § 105-164.6(a)(1) imposes a use tax on "tangible personal property purchased inside or outside the State for storage, use or consumption in this State." However, "storage" is defined as "any keeping or retention in this State for any purpose by the purchaser thereof, *except sale in the regular course of business*, of tangible personal property purchased from a retailer…." N.C. Gen. Stat. § 105-164.3(44) (2005) (emphasis added). Likewise, the statutory definition of "use" specifically excludes "the sale of tangible personal property in the *regular course of business*." N.C. Gen. Stat. § 105-164.3(49) (2005) (emphasis added). Because GDATP "regularly" (i.e., routinely) resells the indirect-charge property to the Government in the course of GDATP's business, GDATP has neither "stored" nor "used" that property under the statutory definitions of those words. Thus, GDATP is not liable for a use tax on the disputed property.

The cases cited in Conclusion of Law number 4 do state a rule of construction for general tax laws. Therefore, the Department adopts Conclusion of Law number 4.

4. The general rule is that "tax statutes are to be strictly construed against the State and in favor of the taxpayer." *In the Matter of Rock-Ola Café*, 111 N.C. App. 683, 686, 433 S.E.2d 236, 237 (1993). "If a taxing statute is susceptible to two constructions, any uncertainty

in the statute or legislative intent should be resolved in favor of the taxpayer." *Lenox, Inc. v. Tolson*, 353 N.C. 659, 664, 548 S.E.2d 513, 517 (2001).

Conclusion of Law number 5 misstates the ruling in *Appeal of Clayton-Marcus Co., Inc.*, 286 N.C. 215, 222, 210 S.E.2d 199, 204 (1974). In that case, the North Carolina Supreme Court prefaced its comments concerning the construction of statutes in favor of or against the taxpayer by stating, "These rules come into play, however, only when there is ambiguity in the statute. When the meaning of the statute is clear, there is no need for construction and the clear intent of the Legislature must be given effect by the courts." 286 N.C. at 219, 210 S.E.2d at 202. In *Clayton* Marcus, the Court was construing the statutory definitions of "storage" and "use." 286 N.C. at 219-220, 210 S.E.2d at 202-203. The definitions of "storage" and "use," considered in *Clayton* Marcus are virtually identical to the statutory definitions of those words in the statutes applicable here. *Compare Id. with* N.C. Gen. Stat. §§ 105-164.3(44), 105-164.3(49) (2005). In *Clayton* Marcus, the Court noted that the initial lack of punctuation in the definition of "storage" created ambiguity, but that an amendment adding a comma now made the meaning "clear." 286 N.C. at 219-220, 210 S.E.2d at 202-203. The definition of "use," standing alone, was also held to be "unambiguous." *Id.* The unambiguous meaning of the statutes means there is no construction in favor of the Petitioner. *Id.* Moreover, in a case decided after *Clayton Marcus*, the North Carolina Supreme Court imposed upon a taxpayer the burden of bringing himself within the parameters of an exception contained in the defining statutory language. *Rent-a-Car Co. v. Lynch*, 298 N.C. 559, 259 S.E.2d 564 (1979). Accordingly, Conclusion of Law number 5 is erroneous and is contrary to the law and the evidence. The Department rejects Conclusion of Law number 5.

~~5. Further, the North Carolina Supreme Court has held that exclusions found within the definitions of the Sales and Use Tax Act (i.e., those in N.C. Gen. Stat. § 105-164.3) are not "exceptions" or "exemptions" which should be construed against the taxpayer. Rather, definitions such as those for "storage," "use," and "business" contained in N.C. Gen. Stat. § 105-164.3, and the exclusions contained within those definitions, are to be read broadly in favor of the taxpayer. As the North Carolina Supreme Court explained, with respect to the definition of "use" in N.C. Gen. Stat. § 105-164.3:~~

> ~~An exclusion, by definition, from the taxable event should be strictly construed against the State under the above mentioned rules for the construction of a taxing statute. It is not an exemption of a favored activity, first brought within the meaning of the taxing provision. It is an original fixing of the outer boundaries of the activity to be taxed.~~

~~*Appeal of Clayton-Marcus Co., Inc.*, 286 N.C. 215, 222, 210 S.E.2d 199, 204 (1974). Therefore, the general rule of tax statute construction applies in this case and the cases cited by the Department contending otherwise, *Henderson v. Gill*, 229 N.C. 313, 49 S.E.2d 757 (1948) (concerning whether a florist qualified as a farmer and the exemption from tax available to farmers under the listing of exemptions in Part 3 of the North Carolina Sales and Use Tax Act), and *Hatteras Yacht Club v. High*, 265 N.C. 653, 144 S.E.2d 821 (1965) (concerning whether yachts qualified as motor vehicles and the lower tax applicable to motor vehicles under N.C. Gen. Stat. § 105-164.4 (as in effect of the years at issue)), are inapposite as neither case~~

~~concerned an exclusion contained in a term defined by N.C. Gen. Stat. § 105-164.3 as was the issue before the Court in *Clayton-Marcus* (which specifically concerned the exclusions/exemptions found in the definition of "use" in N.C. Gen. Stat. § 105-164.3, and it is the meaning of that defined term that is central to this case).~~

The first part of Conclusion of Law number 6 concerning construing the tax statutes in favor of Petitioner is rejected and the remainder of Conclusion of Law number 6 is adopted by the Department.

6. ~~In addition to construing the tax statutes in favor of GDATP, t~~**T**he general rule also includes giving words "their common and ordinary meaning, nothing else appearing." *Appeal of Clayton-Marcus Co., Inc.*, 286 N.C. at 220, 210 S.E.2d at 202-03.

Conclusion of Law number 7 is rejected by the Department as the statute cited therein, N.C. Gen. Stat. § 105-164.3(1k) was not in existence at the time of the assessment in question, and is thus in conflict with the record, wherein the ALJ limited consideration to the statutes in force at the time, rather than their current version. (Tr. at 85-86).

~~7. "Business" is defined for this and other purposes of the North Carolina sales and use tax law as any activity engaged in by a person "with the object of gain, profit, benefit, or advantage, either direct or indirect." N.C. Gen. Stat. § 105-164.3(1k). Because the sales price the Government paid GDATP for the disputed property was more than the amount GDATP paid for the property (Tr. at 49-50), **GD**ATP knew it would, and in fact did, receive a "profit" and "gain" from those sales. Moreover, as those resales were required to be made under the Contracts, they were undertaken for GDATP's "benefit" and "advantage." Thus, GDATP's resales of the disputed property were part of GDATP's "business" as the term "business" is defined in N.C. Gen. Stat. § 105-164.3(1k). *See Appeal of Clayton-Marcus Co., Inc.*, 286 N.C. at 219-20, 210 S.E.2d at 203:~~

> ~~Where, however, the statute, itself, contains a definition of a word used therein, that definition controls, however contrary to the ordinary meaning of the word it may be. *Johnston v. Gill, Comr. of Revenue*, 224 N.C. 638, 32 S.E.2d 30. The courts must construe the statute as if that definition had been used in lieu of the word in question. If the words of the definition, itself, are ambiguous, they must be construed pursuant to the general rules of statutory construction, including those above stated [i.e., against the State and in favor of the taxpayer, including exclusions contained within those definitions].~~

The Department rejects the portion of Conclusion of Law number 8 which refers to N.C. Gen. Stat. § 105-164.3(1k) for the reasons above stated. The remainder of Conclusion of Law number 8 is adopted by the Department.

8. "Regular" is defined by Webster's Ninth New Collegiate Dictionary as "recurring, attending or functioning at fixed or uniform intervals."[3] ~~Construing "regular" to~~

[3] Mr. Stewart testified there is no statutory definition for "regular" and he did not recall the Department referring to a dictionary to determine if the frequency of **GD**ATP's resales of indirect-charge property to the Government were a regular part of the conduct of **GD**ATP's business. (Tr. at 132-133).

~~mean "recurring" or "routine" is further compelled by the definition of "business" in N.C. Gen. Stat. § 105-164.3(1k), for "business" is the noun in the phrase "regular course of business" that the adjective "regular" qualifies. The definition of "business" in N.C. Gen. Stat. § 105-164.3(1k) makes it indisputable that "regular" sales in the context of the use tax means all sales other than those that are "occasional" or "isolated."~~

Conclusion of Law number 9 is adopted by the Department.

9. "Course of business" is defined by Black's Law Dictionary (9th ed. 2009) as "the normal routine in managing a trade or business." This same definition was quoted with approval by the North Carolina Supreme Court when it construed "regular course of business" to mean sales and other transactions that are "done in a recurring manner, or at fixed or uniform intervals" and are part of the corporation's "normal routine in managing a trade or business" as contrasted from a transaction that is "extraordinary" or "a one-time event."[4] *Lenox, Inc.*, 353 N.C. at 664-65, 548 S.E.2d at 517-18 (internal citations omitted).[5]

Conclusion of Law number 10 is rejected by the Department for the reasons above stated due to reference to N.C. Gen. Stat. § 105-164.3(1k).

~~10. "Regular course of business" was also previously defined to be "descriptive of sales which are ordinarily made by a business in contrast to a bulk sale." BLACK'S LAW DICTIONARY 1386 (6th ed. 1990). This definition, distinguishing a "regular" (i.e., routine, or recurring) sale from a bulk sale, is consistent with the distinction made in the definition of "business" in N.C. Gen. Stat. § 105-164.3(1k), distinguishing "regular" (i.e., routine or recurring) sales from "occasional" and "isolated" sales.~~

The Department adopts Conclusion of Law number 11.

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[4] Given, *inter alia*, the plain meaning and statutory analysis set forth herein, and the North Carolina case law and regulations cited in this opinion, the Undersigned does not find the external case law cited by the Department to be persuasive. Specifically, in *Raytheon Co. v. Comm'r of Revenue*, 916 N.E.2d 372, 377-79 (2009), the Supreme Judicial Court of Massachusetts based its decision about whether a government contractor's resales of indirect-charge property to the Government were taxable on what it described as unique considerations under Massachusetts case law: "A review of these decisions [the decisions of virtually every other court to consider the issue, including those of Texas, Arizona, California, and Missouri] reveals that none of the courts has taken the interpretive approach to its State's sale for resale exemption that this court consistently has taken." The Undersigned must likewise look to our State's laws, regulations, and cases for guidance. In doing so, I find the Massachusetts decision conflicts with at least two North Carolina Supreme Court decisions: (1) *Lenox, supra*, and its discussion of the meaning to be given to the phrase "regular course of business," and (2) *Park-n-Shop, infra*, holding that the North Carolina sales and use tax law may not be applied in a way that could subject a taxpayer to both a use tax on its purchase of property and a sales tax on its sale of that property. In addition, North Carolina does not draw the distinction under Massachusetts law described in the *Raytheon* case between sales that may be construed as part of the taxpayer's "central focus" or "primary" business and those that may be described as "incidental" or "facilitat[ing]… principal transactions" or otherwise not part of the "inherent nature of the business in question." *Cf.* N.C. Gen. Stat. 105-164.3(1k), which defines a taxpayer's "business" to include such incidental activities undertaken for any "advantage" or "benefit" as well as for "profit" or "gain" for purposes of the North Carolina use taxes; *see also* cases and regulations discussed in ¶ 17, *infra*, as well as 17 N.C.A.C. 07B .1002 (shoe repairer not subject to use taxes on materials purchased by it to repair shoes when those materials are sold by it to its customers), 07B .0808 (same with respect to furniture upholsters), 07B .0803 (cabinet makers), 07B.3702 (auto mechanics), 07B .0802 (installers), 07B .1003 (repairmen), 07B .0807 (seamstresses), and 07B .0810, .0811, and .1901 (refurbishers).

[5] While *Lenox* involved the North Carolina Corporation Income Tax Act, the Undersigned finds it compelling that the North Carolina Supreme Court construed the phrase "regular course of business" in the context of a North Carolina tax statute and did so without the benefit of the Sales and Use Tax Act's definition of "business." *See, Wal-Mart Stores East, Inc. v. Hinton*, 197 N.C. App. 30, 40, 676 S.E.2d 634, 643 (2009) ("If the definition of a word or phrase is not found in the statute, and the meaning of the word or phrase is not otherwise clear, we consider the meaning of the word or phrase in cases where the word or phrase has been defined.")

11. Because the resales by GDATP of the disputed property were "regular" (i.e., routine and recurring) rather than "occasional," "isolated," or "bulk sales," the Undersigned finds the resales were made by GDATP "in the regular course of its business" as that phrase is intended to be applied in N.C. Gen. Stat. §§ 105-164.3(44) (relating to "storage") and 105-164.3(49) (relating to "use").

The Department adopts Conclusion of Law number 12 as modified.

12. Therefore, under the plain meaning of "regular" and the statutory meaning of "business~~,~~" **pursuant to N.C. Gen. Stat. § 105-164.3 (2005),** there is no question that the resales of the indirect-charge property by **GD**ATP to the Government were made in GDATP's "regular course of business." Consequently, GDATP did not "store" or "use" the indirect-charge property, as those terms are defined in N.C. Gen. Stat. § 105-164.3(44) and (49); and thus, GDATP cannot be liable for a use tax pursuant to N.C. Gen. Stat. § 105-164.6 with respect to those items.

Conclusion of Law number 13 is erroneous in that it misstates N.C. Gen. Stat. § 105-164.6(b). The statute says nothing about the tax being imposed only upon the "ultimate or final" purchaser. *Id.* The statute does impose the use tax upon a "purchaser." *Id.* This conclusion of law also mischaracterizes Mr. Stewart's testimony and takes it out of context. In that testimony, Mr. Stewart was asked general questions and qualified his answers by noting "Generally not," and "In a typical transaction." (Tr. at 102). Mr. Stewart never stated that only the "ultimate" purchaser was subject to the tax. Conclusion of Law number 13 is rejected by the Department in that it is supported neither by the evidence nor the law.

~~13. Further, North Carolina imposes a use tax only on the ultimate or final "*purchaser*" (not the ultimate or final "*user*") of tangible personal property when that property is used (whether by the purchaser or anyone else) in North Carolina. N.C. Gen. Stat. § 105-164.6(b). As the Department conceded, the Government is the ultimate purchaser of the disputed property at issue in this case. (Tr. at 98, 100). As Mr. Stewart testified, simply using property within North Carolina does not subject a user of that property to tax because the [use] tax is imposed on the purchaser, i.e., the ultimate purchaser, of the property. (Tr. at 102).~~

Conclusion of Law number 14 is rejected by the Department because the conclusion that only one tax may be imposed on the same tangible personal property is not the rule of the case cited for that proposition and is not a correct statement of the law in this State.

~~14. Only one tax may be imposed on the same tangible personal property, and that tax is imposed on the ultimate or final "sale" and "purchase" of tangible personal property in a transaction or series of transactions. That is, per the North Carolina Supreme Court, a tax may not be imposed on both the purchase for sale of property and on the subsequent resale. *Park-N-Shop, Inc. v. Clayton*, 264 N.C. 218, 220, 141 S.E.2d 294, 296 (1965). Here, the taxable transaction is the resale by GDATP to the Government. However, as in the case of the sale of direct-charge property, because of the Government's immunity, GDATP is prohibited from collecting a sales tax from it to remit to the Department. 17 N.C.A.C. 07B .4201.~~

Conclusion of Law number 15 relates to a Final Decision of the Department in case number 2003-317. (GDATP's Exhibit 40). The decision in case number 2003-317 was based, in part, upon the taxpayer's failure to provide documentation. *Id.* It is impossible to say to what extent the lack of documentation colored that decision, or how it would have been decided if there had been more complete production of certificates of resale. In any event, this conclusion of law need not been reached since it has previously been concluded that Petitioner is exempt from the use tax assessment in this case. Accordingly, Conclusion of Law number 15 is rejected by the Department.

~~15. As Mr. Stewart acknowledged, the Department concluded in Final Decision Doc. No. 2003-317 (**GD**ATP's Exhibit 40), a case with substantially similar facts and found on the Department's website as approved guidance for future application of the North Carolina sales and use tax laws, that the resale of dies by a purchaser "engaged in business as a contract manufacturer specializing in embossing, die cutting and foil stamping of printed materials [(not selling dies)] to its printer customers" was in the regular course of the contract manufacturer's business. Thus, the resales of the dies by the contract manufacturer were the transactions subject to tax, not the contract manufacturer's "purchase" or "use" or "storage" of those items. The fact that the resales of the dies were, in the words of the Department's hearing officer, merely "incidental" to the "true object" of the contract manufacturer's business was inconsequential to the contract manufacturer having to collect and remit a sales tax on its sale of the dies instead of having to pay a use tax on its purchase, use, and storage of the dies. (GDATP's Exhibit 40; Tr. at 108-109, 116). Similarly, to the extent the Department argues that GDATP's sale of disputed property to the Government is "incidental" to the "true object" of the Contracts (e.g. the delivery of biological and chemical detection systems), that argument is unavailing and does not affect the imposition of a sales tax on GDATP's regular and on-going resales of disputed property and not a use tax on its purchase, use, and storage of that property.~~

For the reasons stated above in Conclusion of Law number 15, Conclusion of Law number 16 is also rejected by the Department.

~~16. The decision set forth in Final Decision Doc. No. 2003-317 is restated in 17 N.C.A.C. 07B .3505. (Tr. at 117). This regulation provides that a manufacturer's purchase of tools or other items of tangible personal property used by a manufacturer but not incorporated into, and which do not otherwise become "component" parts of, the manufactured products ordered by the manufacturer's customers are purchases for "resale" if title to the property and the *right* of possession passes from the manufacturer to its customers. See 17 N.C.A.C. 07B .3505. (Tr. at 118). The manufacturer's retention of possession and use of the property to manufacture tangible personal property for sale to its customers is of no consequence. Though the DOR argues this regulation is not relevant to the instant case, notably, the regulation relates to "dies," "molds," and "patterns" which are all items of property specifically listed within the type of property for which title is transferred to the government under FAR § 52.232-16(d)(2)(iii). This regulation describes two transactions: (1) a vendor sells molds, patterns, and dies (i.e., tools) to a manufacturer who uses them in connection with (but not as component parts of) the products it manufactures for its customers; and (2) the manufacturer transfers title to (i.e., sells) these tools to its customers but retains possession of them (they being purchased for the manufacturer's use and possession). Thus, this regulation, consistent with the prohibition against double tax that was recognized by our Supreme Court in *Park-N-Shop v. Clayton*, 264 N.C. 218, 220, 141 S.E.2d 294, 296 (1965), provides that it is the second and only the second transaction (GDATP's~~

resale of the noncomponent property) that is subject to North Carolina sales and use tax. (Tr. at 118).

Conclusion of Law number 17 ties cases to Final Decision Doc. No 2003-317 which is not being considered in Conclusion of Law number 15 above. In addition, this conclusion of law references N.C. Gen. Stat. § 105-164.3(1k) which was not in existence at the time of the assessment. Accordingly, the Department rejects Conclusion of Law number 17.

17. North Carolina's highest courts have also held consistent with the aforementioned Final Decision and regulation. *See*, *e.g.*:

- *Appeal of Clayton Marcus Co., Inc.*, 286 N.C. 215, 210 S.E.2d 199 (1974) – The DOR assessed a use tax on a furniture manufacturer's "purchase of fabrics used in the production of swatch books." The Supreme Court, analyzing the plain meanings of the Sales and Use Tax Act's definition of "use," held that under that definition, the furniture manufacturer's purchase and use of the fabrics to include in its swatch books were not subject to use tax. *Id*. at 222, 210 S.E.2d at 204. The Court so held even though the production and distribution of swatch books were merely incidental to the taxpayer's furniture manufacturing business.

- *In the Matter of Rock-Ola Café*, 111 N.C. App. 683, 433 S.E.2d 236 (1993) – The DOR assessed a use tax on restaurants for bar "munchies" (e.g. peanuts and pretzels) which were provided at no charge to customers, but whose costs were included and recovered in the sale of menu items. The Court of Appeals affirmed the trial court's reversal of the Department's assessment, holding that "the items here involved are not subject to a use tax because the items were purchased for resale." *Id*. at 686, 433 S.E.2d at 237. The Court so held even though the resales of bar "munchies" were incidental to and merely facilitated the sale of the restaurant's menu items. In so holding, the Court of Appeals reiterated that tax statutes (including exclusions contained in the definitions of N.C. Gen. Stat. § 105-164.3) are to be strictly construed against the State (i.e., the Department) and further noted that the Department had the burden of proving that the taxpayer did not purchase the subject property for resale in the regular course of the taxpayer's business and was therefore subject to a use tax. The Department did not meet its burden.

In summary, the Department bases its assessment of use tax in this case on the assertion that GDATP is in the business of manufacturing defense systems, not selling tools, office supplies and other indirect-charge property. In doing so, the Department fails to mention, much less demonstrate, how that can be the case under the definition of "business" in N.C. Gen. Stat. § 105-164.3(1k) (with any ambiguities in that definition being construed in favor of the taxpayer, GDATP). In addition, GDATP's purchase and resale of the indirect-charge property is at least as much a part of its "business" (both as the Department attempts to employ the term in this case as well as applying that term's broader, technical meaning under N.C. Gen. Stat. § 105-164.3(1k)) and the regular conduct of its business as (1) the furniture manufacturer in *Clayton-Marcus* was in the "business" of selling, without separate charge, swatch books; (2) the restaurant in *Rock-Ola Café* was in the "business" of selling, without separate charge, bar "munchies;" (3) the contract manufacturers of print documents in Final Decision Doc. No. 2003-317 and Regulations

~~07B .3503-.3505 and Technical Bulletin 5-2(A) were in the "business" of selling dies and molds; and (4) the government contractors in the two private letter rulings attached to the North~~ **Notice** ~~of Final Determination were in the business of selling indirect-charge property.~~

The Department adopts Conclusion of Law number 18.

18. Just as the Department found in the Notice of Final Determination that GDATP's resales of direct-charge property to the Government were in the "regular course of business," the Undersigned finds that the recurring resales of disputed property by GDATP to the Government also are made in the "regular course of [GDATP's] business" and, therefore, not subject to use tax.

Conclusion of Law number 19 is unsupported by the evidence. The Department does not contend that this provision, by itself, establishes the Petitioner's liability for the use tax assessed in this case. The Department therefore rejects Conclusion of Law number 19.

~~19. To the extent the Department contends that GDATP's purchases of disputed property are taxable under the language of 17 N.C.A.C. 07B .4203, the Department is incorrect. The Department fails to read this regulation *in pari materia* with the other regulations contained in Section 07B .4200 of Title 17 of the North Carolina Administrative Code (i.e., Regulations .4201-.4210). *See*, ¶ 14, *supra*, for reference to the first of this set of regulations, .4201. Regulation .4203, particularly when read in context with the other regulations in Section 07B .4200 of the Administrative Code, merely states that "sales of tangible personal property to contractors for use in performing contracts with the United States Government or its agents and instrumentalities are subject to the ***applicable*** statutory state and local sales or use tax." *Id.* (emphasis added). Though this regulation means that a government contractor is not automatically exempt or immune from state tax, it does not mean that a government contractor is automatically liable for taxes simply because of its status as such. As Mr. Stewart testified, this regulation simply reinforces that there is no different standard of tax for government contractors. (Tr. at 131). Thus, if a particular tax is not applicable because of the nature of the transaction, that tax may not be imposed, even if the taxpayer is a government contractor.~~[6]

Conclusion of Law number 20 is incorrect. There is a statutory presumption that assessments by the Department of Revenue are correct. N.C. Gen. Stat. § 105-241.9(a) (2007) ("A proposed assessment of the Secretary is presumed to be correct.") Therefore, the Department rejects Conclusion of Law number 20.

~~20. Lastly, the Department cites N.C. Gen. Stat. § 105-264 for the proposition that the Department's interpretation of the North Carolina tax statutes are to be considered "*prima facie* correct." N.C. Gen. Stat. § 105-264, however, by its terms applies only when the Department adopts a rule or publishes a bulletin or directive on the law. There is no presumption of correctness given to the Department's interpretation of the applicable law set forth in its briefs or oral argument or even as may be set forth in its Notice of Final Determination or other~~

[6] The Undersigned also notes that neither of the two private letter rulings attached by the Department to the Notice of Final Determination, both of which were issued more contemporaneously with Regulation .4203 than the instant proceeding, makes any reference to that regulation. *See, e.g., Cape Hatteras Electric Membership Corp. v. Lay*, 2011 WL 692361, *7 (N.C. Ct. App. March 1, 2011).

~~correspondence with a taxpayer. *See National Service Ind. v. Powers*, 98 N.C. App. 504, 507, 391 S.E.2d 509, 511 (1990) (the "'prima facie correct' standard does not apply to administrative interpretations.")~~

Conclusion of Law number 21 seeks to apply regulations and directives to this situation that are inappropriate and do not address the facts of this case. The regulations concerning molds, dies, and patterns deal with items that are generally custom-built, whereas the items in this case were more general in nature. Accordingly, Conclusion of Law number 21 is not supported by the evidence and is rejected by the Department.

~~21. The only "rules," "bulletins," or "directives" pertaining to the issue of whether "noncomponent property" (i.e., property purchased by a manufacturer that is not incorporated into a manufactured product) that is sold by a manufacturer to its customer after being purchased and used by the manufacturer in connection with the performance of its manufacturing contract are 17 N.C.A.C. 07B .3503 .3505 and Sales and Use Tax Technical Bulletin 5-2(A). However, these regulations and technical bulletin provide that a manufacturer who purchases and sells (i.e., transfers title and right of possession to) such noncomponent property, yet retains possession of the property for use in connection with performing its contracts, is not subject to use taxes but, instead, must collect and remit a sales tax on its sale of the noncomponent property to its customers unless, as in this case, the customer is the Government or is otherwise immune or exempt from tax.~~

The first sentence of Conclusion of Law number 22 is vague and insufficient, and the second sentence is erroneous because it casts doubt as to whether there are any presumptions to rebut and does not specify what they are. The Department rejects Conclusion of Law number 22.

~~22. In this case, as set forth above, the Undersigned finds that the decision in the Notice of Final Determination regarding the disputed property is not consistent with the applicable rules or law. Therefore, to the extent there even was any presumption that the Department's interpretation was correct, that has been rebutted by GDATP.~~

For the reasons stated in Conclusions of Law above, part of Conclusion of Law number 23 is rejected and only the portion concerning the two private letter rulings attached to and discussed in the Notice of Final Determination portion is adopted by the Department.

23. As the Court of Appeals stated in a recent opinion regarding the Department's attempt to reverse its longstanding administrative interpretation of a tax statute:

> NCDOR argues that we should give deference to its current interpretation of the Special Act, which would required us to ignore the original interpretation that was acquiesced in over a long period of time. *Petty v. Owen*, 140 N.C. App. 494, 500, 537 S.E.2d 216, 200 (2000) ("[A]n administrative interpretation of a statute, acquiesced in over a long period of time, is properly considered in the construction of the statute by the courts."). Although the interpretation by the Secretary is *prima facie* correct, in conducting statutory interpretation we must consider the fact that NCDOR's 1965 interpretation of the Special Act was made

> within the same historical context, and, most likely, with a better understanding of its purpose and implications. Consequently, we give greater weight to that interpretation than the reversal of position in 2000, 35 years later.

Cape Hatteras Electric Membership Corp. v. Lay, 2011 WL 692361, *7 (N.C. Ct. App. March 1, 2011). Likewise, here, the Undersigned gives greater weight to the longstanding interpretation of North Carolina's statutes as embodied in, e.g., 17 N.C.A.C. 07B .3503-.3505, Sales and Use Tax Technical Bulletin 5-2(A), Final Decision Doc. No. 2003-317, and the two private letter rulings attached to the Notice of Final Determination, rather than the DOR's reversal of position in this proceeding.

Conclusion of Law number 24 is adopted by the Department.

24. As the Department has stated in previous filings in this matter, it cannot negotiate its interpretation of the law with taxpayers on a case-by-case basis, but "must consistently apply his interpretation to all taxpayers. *See* N.C. Gen. Stat. § 143B-218." The Undersigned concludes, however, that the Department's decision in the Notice of Final Determination with respect to disputed property not only is inconsistent with the Department's prior interpretations but is contrary to the plain language of North Carolina's statutes and otherwise violates N.C. Gen. Stat. § 150B-23(a).

Conclusion of Law number 25 is adopted by the Department.

25. Petitioner has met its burden of proof, in that it showed by a preponderance of evidence that the Department erred in assessing use tax on the purchase of the indirect charge or disputed property, and by denying Petitioner's claim for exemption from tax under the "sale for resale" exemption. Overcash v. N.C. Dept. Environment and Nat. Resources, 179 N.C. App. 697, 635 S.E. 2d 442 (2006).

ALJ DECISION

The section of the ALJ Decision which states that the Director of the Sales and Use Tax Division shall enter a Final Agency Decision is rejected since the Director of the Sales and Use Tax Division is not the final agency decision-maker for the Department. Also, the ALJ Decision "orders" the Department to make a Final Agency Decision in favor of the Petitioner. This is contrary to the provisions of N.C. Gen. Stat. §§ 150B-34, 150B-36, 150B-40(e), and 150B-42(a), exceeds the jurisdiction of the Office of Administrative Hearings, and is rejected by the Department. The ALJ Decision is re-worded to reflect that the statutes provide that the Department reviews the official record and makes the final decision in this matter. In addition, the Department rejects the portion of the ALJ Decision which states that none of the penalties set forth in the Notice of Final Determination should be imposed. The portion of the ALJ Decision which indicates no use taxes are owed by Petitioner with regard to the Disputed Property is adopted by the Department.

The **Undersigned ALJ** ~~Director of the Sales and Use Tax Division, Department of Revenue shall enter a Final Agency Decision modifying the Notice of Final Determination to~~ find**s** that (i) GDATP's resales of indirect-charge property or disputed property were made in the regular course of business, as contemplated by, *inter alia*, N.C. Gen. Stat. §§ 105-164.6, 105-

164.3(1k), 105-164.3(44), and 105-164.3(49) and, therefore, no use taxes are owed by GDATP with respect to that property ~~and (ii) none of the penalties set forth in the Notice of Final Determination should be imposed~~. ~~Specifically, it is ordered that the Department shall enter a Final Agency Decision holding that GDATP has paid all taxes and interest due associated with the Audit Period and that all penalties shall be waived.~~

FINAL AGENCY DECISION

The Department determines that the Findings of Fact and Conclusions of Law of the ALJ, as adopted by the Department, support the portion of the ALJ's Decision which states Petitioner owes no use tax with regard to the Disputed Property. Based on the foregoing, the Department hereby PARTIALLY UPHOLDS and PARTIALLY ADOPTS the Decision of the ALJ and finds (i) that no additional use taxes are owed by GDAPT with respect to the disputed property, (ii) that the $21,019.58 amount of use tax in dispute and all associated accrued interest should be abated by the Department, and (iii) any penalties set forth in the Notice of Final Determination which are related to the use tax in (ii) which is abated should be abated by the Department, and (iv) the Department shall immediately process the Form NC-5500 and determine whether any additional penalties should be waived under the Department's Penalty Waiver Policy.

APPEAL

Pursuant to N.C. Gen. Stat. § 150B-45, a party wishing to appeal the final decision of the Department in a contested tax case arising under N.C. Gen. Stat. § 105-241.15 may commence such an appeal by filing a Petition for Judicial Review in the Superior Court of Wake County and in accordance with the procedures for a mandatory business case set forth in N.C. Gen. Stat. § 7A-45.4(b) through (f) within 30 days after being served with a written copy of this Final Agency Decision. Before filing a Petition for Judicial Review, a taxpayer must pay the amount of tax, penalties, and interest that this Final Agency Decision states is due. N.C. Gen. Stat. § 105-241.16. The use tax assessed in this matter and any associated accrued interest has been abated, so no tax and interest is due. The Department must process the Form NC-5500 to determine whether penalties should be waived under the Department's Penalty Waiver Policy. Please contact the Department's counsel David D. Lennon and Andrew O. Furuseth for the result of the penalty waiver request.

Under N.C. Gen. Stat. § 150B-47, the Department is required to file the official record in the contested case under review, any exceptions, proposed findings of fact, or written arguments submitted to the Department, as well as the Department's Final Agency Decision, with the reviewing court within 30 days of receipt of the Petition for Judicial Review. Consequently, a copy of the petition must be sent to the following address: North Carolina Department of Revenue, ATTN: Janice W. Davidson, 1429 Rock Quarry Road, Suite 105, Raleigh, North Carolina 27610, at the time the appeal is initiated to ensure timely filing of the record.

This the 4th day of November, 2011.

NORTH CAROLINA DEPARTMENT OF REVENUE

/s/ Janice W. Davidson

Janice W. Davidson
Agency Legal Specialist II
North Carolina Department of Revenue