

CAPITOL MACHINE & EQUIP. CO. LLC §
AND ITS MEMBERS: SUN ENTERPRISES §
LLC, ROBERT W. SHIVER §
702 DAY STREET ROAD §
MONTGOMERY, AL 36108-2532, §

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayer,

DOCKET NO. S. 08-619

v.

STATE OF ALABAMA §
DEPARTMENT OF REVENUE.

FINAL ORDER ON DEPARTMENT'S APPLICATION FOR REHEARING

A Final Order was entered in this case on April 20, 2009 voiding the final assessment in issue. The Order addressed four issues. The Department timely applied for a rehearing and requested that because the final assessment was due to be voided based on Issue (1), a discussion of Issues (2), (3), and (4) should be removed from the Order. The Taxpayer does not contest the Department's application, except concerning Issue (2). Consequently, the April 20, 2009 Final Order is voided, and the following findings and conclusions are entered in the case.

ISSUES

The Taxpayer manufactures and sells pneumatic insulation blowing machines and related parts. The issues in this case are as follows:

(1) Are the blowing machines and related parts machines used in processing tangible personal property, and thus taxable at the reduced one and one-half percent sales tax "machine" rate levied at Code of Ala. 1975, §40-23-2(3);

(2) Is the Department barred from assessing the Taxpayer for July through October 2004 because those months are outside of the statute of limitations for assessing tax at Code of Ala. 1975, §40-2A-7(b)(2);

(3) Are the individual members of the LLC Taxpayer personally liable for the sales tax in issue; and,

(4) Should the penalty assessed by the Department be waived for reasonable cause pursuant to Code of Ala. 1975, §40-2A-11(h).

FACTS

The facts are undisputed. As indicated, the Taxpayer manufactures pneumatic insulation blowing machines and related parts (“equipment”). It sells the equipment primarily to insulation contractors, who use the equipment to blow both loose-fill and wet-spray insulation into buildings.

Insulation contractors purchase insulation in compact form from the manufacturer at retail.¹ If a contractor is blowing loose-fill insulation, the equipment operator sets the engine speed and adjusts various gates and valves on the equipment to produce the desired insulation density. The operator then feeds the compressed insulation into the equipment. The compact insulation is preconditioned by an auger, and is fed through a control gate into shredders. The shredders convert the unidirectional fibers in the insulation into multidirectional fibers, which improves the material’s insulating qualities. The shredded insulation then flows from the shredders into an air lock feeder. The feeder contains rotating, sealed veins, which provide a constant air stream on the

¹ The Department examiner noted in his audit report that insulation is a building material that should be sold to the end user, the insulation contractor, at retail. I agree. But that has no relevance to whether the Taxpayer’s equipment constitutes a machine used in processing the insulation for purposes of the machine rate statute.

insulation. The air expands the fibers in the insulation to condition its density. The insulation is further conditioned to its desired density when it bounces off the hose walls while being blown onto the desired location. The blown insulation covers four times more area than it did in compacted form.

If the insulation is intended for open walls or the underside of ceilings, a contractor may install wet-spray insulation, which is a type of fiberglass or cellulose insulation that adheres to the surface onto which it is sprayed. Wet-spray insulation is also purchased by the insulation contractor at retail in compact form, and is shredded and otherwise prepared for application by the Taxpayer's equipment the same as loose-fill insulation.

With wet-spray insulation, however, the blower is equipped with an attached water pump. The pump extracts water from a water spigot or other outside source, and pumps it through a nozzle attached to the end of the hose through which the insulation is blown. The water is then sprayed as a mist into the air in front of the insulation hose. The mist mixes with the blown insulation, which triggers an adhesive in the insulation that causes it to stick to the wall or ceiling.

The Taxpayer charged its customers sales tax on the blowing equipment at the reduced one and one-half percent machine rate during the period in issue. The Department audited the Taxpayer and determined that the equipment was taxable at the general four percent rate. It also determined that the Taxpayer had failed to collect tax on retail sales to customers located outside of Alabama that had picked up the equipment at the Taxpayer's location in Alabama.

The Taxpayer conceded that it owed sales tax on its sales to out-of-state customers that were closed in Alabama. It consequently paid the tax due on those sales at the one and one-half percent machine rate, except concerning a sale in August 2004, which the Taxpayer claims is outside the statute of limitations for assessing the tax.

The Department subsequently entered a preliminary assessment against the Taxpayer, and its two members, on December 17, 2007. The Taxpayer petitioned for a review of the preliminary assessment. The Department denied the petition, and entered the final assessment in issue.

ANALYSIS

Issue (1). Does the Machine Rate Apply?

The Department argues that the machine rate does not apply because the compressed insulation is already in marketable form when it is purchased by the insulation contractor. It contends that the Taxpayer's machines do not convert the insulation into a new or different product. Rather, according to the Department, "[a]ll the Taxpayer's machines do is fluff the insulation that had been compressed. The Taxpayer's machine does not do anything to change or alter the basic nature of the insulation. The insulation is compressed by its manufacturer and all that happens is that the Taxpayer's insulation machines uncompress the insulation." Department's Brief at 5.

The Taxpayer asserts that the compressed insulation is not in its final usable form when purchased by a contractor, and that the insulation must be run through and processed by the blowing machine before it can be applied to the intended surface. It

argues that the equipment is not a mere applicator, such as a paint sprayer, but rather fundamentally alters the shape, size, and nature of the insulation. The Taxpayer thus contends that the equipment "processes" the insulation within the purview of the machine rate statute. I agree.

Section 40-23-2(3) levies a reduced one and one-half percent sales tax on "machines used in mining, quarrying, compounding, processing, and manufacturing" tangible personal property. In *Sizemore v. Franco Distributing Co., Inc.*, 594 So.2d 143, (Ala. Civ. App. 1991), the Alabama Court of Civil Appeals discussed the meaning of "processing" within the context of the machine rate statute, as follows:

When ascertaining the meaning of the term "processing" as used in §40-23-2(3) and its predecessor, our supreme court stated the following:

"We have had occasion to quote approvingly in several cases, *State v. Advertiser Co.*, 257 Ala. 423, 428, 59 So.2d 576, 579 (1952); *Curry v. Alabama Power Co.*, 243 Ala. 53, 60, 8 So.2d 521, 526-27 (1942), the following definition of the word 'process' as given by Webster's New International Dictionary, 2nd Ed.:

"A series of actions, motions, or operations definitely conducing to an end, whether voluntary or involuntary; progressive act or transaction; continuous operation or treatment; a method of operation or treatment, esp. in manufacture; . . .

"To subject to some special process or treatment. . . . To subject (esp. raw material) to a process of manufacture, development, preparation for the market, etc; to convert into marketable form, as livestock by slaughtering, grain by milling, cotton by spinning, milk by pasteurizing, fruits and vegetables by sorting and repacking To make usable, marketable, or the like, as waste matter or an inferior, defective, decomposed substance or product, by a process, often a chemical process To produce or copy by photo-mechanical methods; to develop, fix, wash and dry, or otherwise treat (an exposed film or plate)."

Southern Natural Gas Co. v. State, 261 Ala. 222, 227, 73 So.2d 731, 735 (1954). Under this definition, it is apparent that the word "process" is synonymous with the expressions "preparation for market" and "to convert into marketable form." *Id.*

Franco, 594 So.2d at 146.

The Taxpayer's blowing equipment clearly processes the compacted insulation within the scope of the above definition of the term. While the compressed insulation is obviously manufactured before it is purchased by an insulation contractor, it is not ready for its intended final use. Rather, the contractor must use the Taxpayer's equipment to shred, expand, and otherwise prepare and process the insulation into usable form. The evidence confirms that the compacted insulation cannot be effectively applied unless it is processed and blown into place using the Taxpayer's equipment. As indicated by the above quote from *Franco*, "process" includes "[t]o make usable, marketable, or the like, . . . by a process," Only by processing the compacted insulation through the Taxpayer's equipment is the insulation converted into its usable form.

I also disagree with the Department's claim that the machine rate does not apply because "the bags of insulation do not become a new or different product and no new tangible personal property is created," Department's Brief at 3. Neither the machine rate statute, §40-23-2(3), nor Alabama case law on the issue require that a new or different product must be created. The Department regulation on the issue, Reg. 810-6-4-.17.05, also gives examples of processing that do not involve the creation of a new product. For example, the regulation provides that fruits and vegetables are processed by sorting and repacking. No new or different product is created in that instance, yet the machine rate still applies.

In any case, the Taxpayer's blowing equipment clearly alters the insulation and creates a new product that is distinct from the compacted insulation that is fed into the equipment. The equipment does not merely fluff the insulation. Rather – "By shredding the insulation, converting it from unidirectional fiber into multidirectional fiber, and further expanding the insulation fibers through the introduction of an air stream, the Equipment alters the physical state and density of the compressed insulation to produce the processed loose-fill insulation, a 'new and different product.'" Taxpayer's Reply Brief at 5. And concerning the wet-spray insulation, the water further alters the density of the insulation and triggers the adhesive in the insulation, which causes it to adhere to the intended surface.

Issue (2). The Statute of Limitations.

This issue is moot given the holding in Issue (1), except concerning one sale in August 2004 that the Taxpayer failed to report and pay tax on.

The Department entered a preliminary assessment against the Taxpayer on December 17, 2007. The Department can generally only assess tax within three years from the due date of the applicable return. Code of Ala. 1975, §40-2A-7(b)(2). Consequently, the Department could normally only assess the Taxpayer for the month of November 2004 forward.² The Department nonetheless assessed the Taxpayer back to July 2004 based on §40-2A-7(b)(2)b. That statute provides that if a taxpayer omits more than 25 percent of the tax due on a return, the Department can assess the taxpayer back six years.

² The November 2004 return was due December 20, 2004, or within three years from when the preliminary assessment was entered on December 17, 2007.

The Department applied the 25 percent omission statute based on its claim that the Taxpayer had incorrectly reported and paid tax at the machine rate, and thus underreported by more than 25 percent. But because the machine rate does apply, the Taxpayer did not underreport by 25 percent, in which case the pre-November 2004 months are barred from being assessed.

Issues (3) and (4) are moot.

The final assessment in issue is voided.

This Final Order on Department's Application for Rehearing may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered June 9, 2009.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

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