

MERCEDES-BENZ US
INTERNATIONAL, INC.
1 MERCEDES DRIVE
VANCE, AL 35490-9310,

Taxpayer,

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. S. 09-519

FINAL ORDER

The Revenue Department assessed Mercedes-Benz US International, Inc. ("Taxpayer") for State sales tax for January 2005 through December 2007. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on November 17, 2009. Warren Matthews, Robert Rutherford, and Matthew Kendrick represented the Taxpayer. Assistant Counsel Wade Hope represented the Department.

ISSUES

The Taxpayer manufactured motor vehicles in Alabama during the period in issue. It assembled the vehicles using parts manufactured by various parts suppliers. Those suppliers manufactured the parts using presses, molds, dies, and other machines, i.e., tooling, that they had purchased from various tooling vendors. The suppliers at all times had possession and use of the tooling. For reasons explained below, however, the suppliers at some point transferred title to the tooling to the Taxpayer. They thereafter leased the tooling back from the Taxpayer for a nominal sum.

The primary issue is whether taxable retail sales occurred when the suppliers transferred title to the tooling to the Taxpayer. If the transfers of title constituted taxable

retail sales, a second issue is whether the tooling purchased by some of the suppliers pursuant to valid statutory tax abatements was exempt from sales tax, and thus should be removed from the final assessment.

FACTS

The facts are largely undisputed.

The Taxpayer contracted with its German parent company, Daimler Benz, to manufacture Mercedes vehicles at its facility in Vance, Alabama during the period in issue. The Taxpayer did not manufacture any of the parts used in producing the vehicles. Rather, it contracted to purchase the parts from unrelated suppliers.¹

The process for obtaining the required parts began when the Taxpayer's parent in Germany determined the engineering and design specifications for the various parts. That occurred approximately 20 months before actual production of the vehicle model began in Alabama. The parent then negotiated with and entered into tentative agreements for various tier one suppliers to manufacture and then sell the parts to the Taxpayer.

The Taxpayer and each tier one supplier entered into a Master Terms Direct Purchasing Agreement ("Master Agreement") that generally governed the relationship between the parties. The Master Agreement required the supplier to purchase the tooling needed to make the part. It also provided that the Taxpayer would take legal title to the tooling, and thereafter lease the tooling back to the supplier for \$1.00. An addendum to

¹ The suppliers that sold parts directly to the Taxpayer are known as tier one suppliers, the suppliers that provided parts to the tier one suppliers are known as tier two suppliers, and so forth.

the Master Agreement specified that title would pass to the Taxpayer when the tooling vendor delivered the tooling to the supplier.

The Taxpayer thereafter issued the supplier a purchase order for the tooling. The purchase order directed the supplier to purchase the tooling, and provided that the supplier would transfer legal title to the tooling to the Taxpayer at some point in the future.

After receiving a tooling purchase order, the supplier negotiated with and subsequently contracted for a tooling vendor to make the required tooling. The Taxpayer had no role or input concerning the tooling vendor selected by the supplier. The supplier purchased the tooling in its own name, pledged its own credit, paid for the tooling, and supervised the production of the tooling by the tooling vendor to ensure that it met specifications. The supplier was also responsible for and bore the risk of loss if the tooling did not perform as required.

The tooling vendor delivered the finished tooling to the supplier approximately 13 months before the start of production. The Taxpayer then issued purchase orders to the supplier for parts that it used to assemble test vehicles. Vehicle testing began about 12 months before the start of production, and continued until about 2 to 4 months before production began. After testing, the supplier began producing and selling to the Taxpayer the parts needed to assemble the vehicles distributed to its dealers for sale. The Taxpayer paid the supplier for all parts, including those used to construct the test vehicles.

The Taxpayer and the supplier entered into a bill of sale for the tooling approximately four months before the start of production. The bill of sale acknowledged that the supplier had good title to the tooling, and that it was transferring that title to the Taxpayer with the

bill of sale. The Taxpayer thereafter reimbursed the supplier for the tooling. The parties also executed a Lease Agreement whereby the Taxpayer leased the tooling back to the supplier for \$1.00.

A Taxpayer witness testified at the November 17 hearing that the only reason title to the tooling was transferred from the supplier to the Taxpayer was to ensure that if the supplier filed for bankruptcy or otherwise had financial problems, the tooling would be protected from the supplier's creditors, and the Taxpayer could take possession of and move the tooling to another supplier. That testimony was not disputed by the Department.

The Taxpayer never had possession of or used the tooling. Rather, the supplier at all times exclusively used and had possession of the tooling through the assembly life cycle of the particular model on which the part was used. The supplier was also required to repair or replace the tooling, if required, and to insure and pay the applicable property tax on the tooling. The supplier otherwise had all other incidents of ownership to the tooling, except the Taxpayer depreciated the tooling for income tax purposes. The supplier disposed of the tooling after it was no longer needed to produce parts.

The Department audited the Taxpayer for the period in issue and determined that because legal title to the tooling was transferred by the suppliers to the Taxpayer, the Taxpayer had purchased the tooling from the suppliers at retail. It accordingly assessed the Taxpayer for sales tax on the tooling it had "purchased" from its Alabama-based suppliers.

The Department concedes that some of the Alabama-based suppliers in issue were not licensed retailers, although the number that were not licensed is not in evidence. There

is also no evidence whether the suppliers paid sales or use tax to Alabama or any other state when they purchased the tooling from the tooling vendors.

Finally, the Taxpayer argues that even if it is deemed to have purchased the tooling at retail, some of the tooling still should not be taxed because it was previously purchased tax-exempt by the supplier pursuant to a statutory tax abatement. There is no evidence, however, indicating which suppliers had valid tax abatements.

Other relevant facts are stated as needed in the below analysis of the issues.

ANALYSIS

The Department argues that the Taxpayer purchased the tooling from the suppliers at retail because legal title to the tooling passed from the suppliers to the Taxpayer. It contends that while the retail seller is generally required to collect and remit sales tax to the Department, the Taxpayer, as the purchaser in this case, was required to remit sales tax directly to the Department pursuant to its Department-issued direct pay permit. As discussed below, a direct pay permit allows a business that uses tangible personal property for both taxable and nontaxable purposes to purchase all property sales tax free, and then remit sales tax directly to the Department on that property used for a taxable purpose during the reporting period. See, Department Reg. 810-6-4-.14.

The Taxpayer asserts that while it did have technical legal title to the tooling, it did not purchase the tooling at retail for Alabama sales tax purposes, and thus is not liable for the sales tax in issue. Rather, it contends that the suppliers purchased the tooling at retail from the tooling vendors and subsequently used the tooling in Alabama, and were thus liable for Alabama use tax on the tooling. I agree.

The Alabama use tax is levied on “the use, storage, or other consumption in this state of tangible personal property . . . purchased at retail. . . .” Code of Ala. 1975, §40-23-61(a). Two events must occur for the use tax to apply. First, the property in issue must be purchased at retail. Second, the property must be purchased for and actually used in Alabama. See generally, *Boyd Brothers Transp., Inc. v. State Dep’t of Revenue*, 976 So.2d 471 (Ala. Civ. App. 2007)

“Retail sale” is defined in pertinent part for use tax purposes at Code of Ala. 1975, §40-23-60(5) as “[a]ll sales of tangible personal property except those above defined as wholesale sales.” That section further defines “retail sale” to include “[s]ales of tangible personal property . . . to manufacturers . . . which are used or consumed by them in manufacturing,”

The suppliers in issue were manufacturers because they manufactured the parts used by the Taxpayer to assemble motor vehicles. It is also undisputed that the suppliers used the tooling to manufacture the parts. The sales of the tooling by the tooling vendors to the suppliers were thus “[s]ales of tangible personal property . . . to manufacturers . . . which are used . . . by them in manufacturing. . . .,” and constituted retail sales to the suppliers pursuant to §40-23-60(5).

The Alabama Court of Civil Appeals held in *State v. Advertiser Co.*, 337 So.2d 942 (Ala. Civ. App. 1976), that sales to unlicensed sellers did not qualify as wholesale sales, and were thus retail sales, even if the sales were for resale. Consequently, in addition to the fact that the sales by the tooling vendors to the suppliers met the definition of “retail sale” at §40-23-60(5), the sales of tooling to those suppliers that were not licensed retail

merchants did not qualify as wholesale sales, and thus for that reason also constituted taxable retail sales to the suppliers.

“Use” is defined for use tax purposes at Code of Ala. 1975, §40-23-60(8) as “[t]he exercise of any right or power over tangible personal property incident to the ownership of that property, or by any transaction whereby possession is given. . . .”

The above definition includes the use of tangible personal property in Alabama by the titled owner, and also the use of such property in Alabama by someone other than the titled owner. “The language of the (use tax) statute does not seem to indicate that the legislature intended to predicate the (use) tax upon one who held technical legal title and no other.” *Associated Contractors v. Hamm*, 172 So.2d 385, 387 (1965).

Consequently, while the Taxpayer at some point held technical legal title to the tooling, the agreements between the Taxpayer and the suppliers clearly were “transaction(s) whereby possession (of the tooling) (was) given” to the suppliers, who exclusively possessed and used the tooling in Alabama. The suppliers thus used the tooling in Alabama pursuant to the §40-23-60(8) definition of “use.” Having purchased the tooling at retail with the intent of using it in Alabama, and having actually used the tooling in Alabama, the suppliers were clearly liable for Alabama use tax on the tooling.²

² As discussed, there is no evidence whether any of the suppliers paid sales or use tax when they purchased the tooling at retail from the tooling vendors. If sales or use tax was paid to another state, the suppliers would be entitled to a credit against their Alabama use tax liability for the tax previously paid. Code of Ala. 1975, §40-23-65. If the suppliers paid sales tax on the tooling in Alabama, the tooling would be exempt from Alabama use tax. Code of Ala. 1975, §40-23-62(1). Otherwise, Alabama use tax would be due.

The Administrative Law Division's decision in *Carlisle Engineered Products, Inc. v. State*, U. 99-524 (Admin. Law Div. 4/17/2000), 2000 WL 521109, is directly on point. Carlisle was an automobile parts manufacturer in Alabama. It contracted with automobile manufacturers to produce parts to be used by the manufacturers in assembling automobiles. A transaction between Carlisle and an automobile manufacturer was in substance identical to the transactions between the parts suppliers and the Taxpayer in this case. An automobile manufacturer issued a purchase order for Carlisle to obtain molds, i.e., tooling, from a mold vendor, and to thereafter use the molds to produce parts for the manufacturer. The purchase order specified that the automobile manufacturer would hold legal title to the molds. Carlisle paid the mold vendor for the molds, and in turn billed the manufacturer for the molds (plus other costs). Carlisle had possession of and used the molds in Alabama through their useful life, and eventually disposed of the molds.

The Department assessed Carlisle for Alabama use tax on its use of the molds in Alabama. It argued that Carlisle's use and control of the molds in Alabama triggered the use tax, notwithstanding that the automobile manufacturer held technical legal title to the molds. The Department's brief filed with the Administrative Law Division in *Carlisle* reads in pertinent part as follows:

The issue of whether a Taxpayer in Alabama must have legal title to property used in Alabama before the Alabama use tax can apply was decided in the case of *Associated Contractors v. Hamm*, 172 So.2d 385 (1965). *Associated Contractors* involves the collection of the State use tax from a contractor who used tangible personal property to fulfill a contract with the United States Government. *Id.* at 386. The contract between the government and Associated Contractors provided that Associated Contractors was to furnish labor, materials, tools, machinery and equipment, facilities, supplies, and services and do all things necessary for the completion of the work specified in the contract. *Id.* In making its holding, the Court interpreted the

predecessor statutes of *Ala. Code* §40-23-60 et seq. to determine that Associated Contractors had possession of the above items from the time they were purchased until they were used by Associated Contractors in performing the work under the contract. Thus, Associated Contractors had sufficient title, control and possession of the materials used to perform the contract when the materials came to rest in Alabama so as to invoke the use tax. *Id.* at 387. The *Associated Contractor* Court further noted that the language of the use tax statute did not indicate that the legislature intended that the use tax be imposed only on one with technical legal title and no other. *Id.*

In the instant case, according to the Taxpayer, once it receives a purchase order from a customer to produce an automobile part, it issues a purchase order on behalf of the customer, and the vendor provides the molds or patterns directly to Taxpayer and invoices Taxpayer for that mold or pattern. (cite omitted) Once the mold or pattern is provided to Taxpayer by the vendor, Taxpayer tests the mold or pattern and prepares test parts on behalf of its customer. Taxpayer's product is then produced using this mold or pattern. (cite omitted) Therefore, Taxpayer has control of the mold or pattern used to produce, tangible personal property – automobile parts. Consequently, as the Taxpayer necessarily has to have control over the molds/patterns in order to produce their product, Taxpayer has sufficient title, control and possession of these patterns or molds when they come to rest in Alabama to invoke the use tax statute.

Department's Brief in *Carlisle* at 4 – 6.

The Administrative Law Division agreed with the above rationale, and held that the facts in *Carlisle* were “sufficiently similar to the facts in *Associated Contractors* to find that (Carlisle) ‘had sufficient title, control and possession of the (molds) when they came to rest in this state to invoke the (use tax) statute.’ *Associated Contractors*, 172 So.2d at 387.”

Carlisle, U. 99-524 at 6.³

³ The Department appealed the Administrative Law Division's Final Order on Rehearing in *Carlisle* to the Tuscaloosa County Circuit Court, but only disputed that part of the Order involving the unrelated use tax “ingredient or component part” provision at Code of Ala. 1975, §40-23-60(5). The Circuit Court affirmed the Division's holding on that issue, from which no appeal was taken. The Department's brief in the case is a public document on file

The Department's stated position in *Carlisle* directly supports the Taxpayer's position in this case. Just as Carlisle had sufficient control, possession, and use of the molds so as to be liable for Alabama use tax on the molds, the parts suppliers in this case had sufficient control, possession, and use of the tooling in issue so as to be liable for Alabama use tax on the tooling.

The only fact disputed by the parties in this case is when legal title to the tooling passed from the suppliers to the Taxpayer. The Department contends that the addendum to the Master Agreement controlled, and that title passed to the Taxpayer instantly when the tooling vendors delivered the tooling to the suppliers. The Taxpayer argues, however, that the parties never used the addendum form, and that title passed with the bill of sale approximately four months before the start of production.⁴ The above issue need not be decided, however, because as discussed, the suppliers' use of the tooling in Alabama, whether they had legal title or not, subjected the suppliers to Alabama use tax on the tooling.

Both sides agree that in matters of taxation, substance must govern over form. *State v. Marmon Indus., Inc.*, 456 So.2d 798 (Ala. Civ. App. 1984). I also agree.

with the Administrative Law Division, see, Code of Ala. 1975, §40-2A-9(m), and was also submitted as part of the record on appeal to the Circuit Court.

⁴ The Department attorney acknowledged in the Department's post-hearing brief that title passed to the Taxpayer with the bill of sale. "Furthermore, a formal bill of sale was entered into between the suppliers and the Taxpayer whereby the dies and tooling equipment were actually sold and title was transferred (by the bill of sale) to the Taxpayer." Department's Brief at 4.

The substance and purpose of the transactions between the Taxpayer and its tier one suppliers was for the suppliers to manufacture and sell automobile parts to the Taxpayer. There is no evidence that the suppliers were in the business of selling tooling at retail, as required for sales tax to apply, and the substance of the transactions did not involve a retail sale by the suppliers to the Taxpayer.

The form of the transactions did include a technical transfer of title to the Taxpayer. The Taxpayer then leased the tooling back to the supplier. But the undisputed reason for the transfer of title and lease back was to ensure that if the supplier went bankrupt or a judgment creditor sought to attach the supplier's assets, the tooling would be protected, and the Taxpayer could thereafter move the tooling to another supplier. But other than the Taxpayer holding technical legal title, the substance of the transactions was that the suppliers at all times possessed and used the tooling, and exercised all other legal incidences of ownership to the tooling.⁵

Finally, the fact that the Taxpayer was a direct pay permit holder has no bearing on whether the Taxpayer owes sales tax on the tooling. To begin, the Department's claim that the Taxpayer should pay the tax under its direct pay permit presupposes that the Taxpayer purchased the tooling in an otherwise taxable retail sale. As discussed above, that was not the case. A direct pay permit only changes when sales tax should be paid. It cannot make

⁵ The Taxpayer did depreciate the tooling for income tax purposes. But the Alabama Supreme Court has held that that fact has no bearing on the sales tax consequences of a transaction. "Though appellant may have claimed depreciation in reference to income tax, this would not affect the sales tax." *Montgomery Aviation Corp. v. State*, 154 So.2d 24, 27 (Ala. 1963).

an otherwise nontaxable transaction taxable. If a direct pay permit holder's purchase of tangible personal property is not an otherwise taxable retail sale, the holder will never be liable for sales tax on the subject property. And tax is due under a direct pay permit only when the holder uses the property for a taxable purpose. As discussed, the Taxpayer in this case never used the tooling for any purpose.

The taxable use tax transactions occurred when the suppliers purchased the tooling at retail and then used it in Alabama. The suppliers were not in the business of and did not resell the tooling to the Taxpayer at retail. The Taxpayer thus is not liable for Alabama sales tax on the tooling.

The issue concerning the suppliers with tax abatements is pretermitted by the above holding.

The final assessment in issue is voided.

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

Entered February 24, 2010.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

cc: J. Wade Hope, Esq.
Warren C. Matthews, Esq.
Joe Cowen
Mike Emfinger