HOLCIM, U.S., INC. c/o WHITNEY COMPTON, CPA 2000 POWERS FERRY ROAD MARIETTA, GA 30067-1401,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 11-381
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

This appeal involves partially denied refunds of State sales tax and State use tax for April 2002 through March 2005 requested by Holcim, U.S., Inc. ("Taxpayer"). The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(c)(5)a. A hearing was conducted on October 20, 2011. Whitney Compton and Elaine Bialczak represented the Taxpayer. Assistant Counsel Margaret McNeill represented the Department.

FACTS

The Taxpayer operated two cement manufacturing plants in Alabama during the period in issue. The Department audited the Taxpayer for sales and use tax for the period. The audit began in 2005. The parties subsequently executed waivers of the statute of limitations allowing the Department until January 31, 2009 to enter preliminary assessments for the audit period, and also allowing the Taxpayer until that date to petition for refunds for the period.

Given the large number of Taxpayer transactions within the three year audit period, the parties agreed that the Department examiner would perform a "block sample" audit of the Taxpayer's records. The parties initially agreed that four sample months would be

used. They later agreed to use only two months, August 2004 and February 2005.

The Department entered a sales tax preliminary assessment against the Taxpayer on April 18, 2008, and use tax and direct pay sales tax preliminary assessments on August 6, 2008. The Department later issued revised preliminary assessments for all three tax types, but never entered final assessments.

The Taxpayer filed a petition for review of the preliminary assessments on November 20, 2008, and also submitted petitions for refund at that time.

The Department's Sales and Use Tax Assessment Officer conducted an informal conference concerning the preliminary assessments/refund petitions on January 5, 2010. The Assessment Officer subsequently concluded in a detailed March 17, 2010 letter that the sales tax preliminary assessment should be voided, and that the use tax and sales tax direct pay preliminary assessments should be reduced.

The Taxpayer's representatives asked the Assessment Officer to reconsider various issues addressed in the Officer's March 17 letter. The Assessment Officer subsequently decided most of those issues in the Taxpayer's favor, and so responded by another detailed letter dated April 29, 2011. That letter stated that the Department would recompute the Taxpayer's liabilities and notify the Taxpayer of the results.

The Department's Assistant Assessment Officer ("Assistant Officer") subsequently reviewed the audit and made the adjustments agreed to by the Assessment Officer. She also reviewed various items purchased in the test months for the purpose of determining if the purchases were "ordinary," in which case the tax underpaid or overpaid on the item should be projected over the entire audit period, or "extraordinary," and thus treated as a nonrecurring transaction and not projected over the audit period.

The Assistant Officer determined that some purchases on which the Taxpayer had overpaid tax, and which the examiner had treated as ordinary and projected, were extraordinary purchases that should not be projected. The primary dispute in the case involves six of those "refund" transactions that the Assistant Officer changed from ordinary, projected purchases to nonrecurring, one-time purchases. The items involved in those transactions are identified and discussed below.

The Taxpayer's refund petitions were deemed denied by operation of law in late May 2009. The Taxpayer consequently appealed the denied refunds to the Administrative Law Division on May 10, 2011, before the Department notified it of the final audit adjustments and the reduced refunds due, because the two year statute of limitations for appealing the deemed denied refunds was about to expire.

The Assistant Officer sent her audit adjustments and schedules to the Taxpayer's representatives in early June 2011. She also notified the Taxpayer that it was entitled to a use tax refund of $64,166.39 and a direct pay sales tax refund of $32,039.31, with interest. The Taxpayer contends on appeal that those refund amounts are too low.

In October 2011, the Taxpayer notified the Administrative Law Division that it also contested the taxability of silo pinch valve sleeves that the Department audit had taxed at the four percent general rate. The sleeves are a part of the machines used by the Taxpayer to manufacture the cement. The Taxpayer claims that the sleeves erode or wear during use, and thus become a nontaxable ingredient or component part of the cement. The issue of whether the pinch valve sleeves become a nontaxable ingredient or component part of the cement was not raised in the Taxpayer's refund claims, and was not otherwise previously addressed by the Department.

Other relevant facts are stated as necessary in the below analysis.

ANALYSIS

In a "block sample" sales and use tax audit, a taxpayer's liability for the audit period is estimated by reviewing the taxpayer's sales/use tax transactions in two or more test months in the period. The taxpayer may have overpaid tax on some transactions during the test months, and underpaid on others. The net amount overpaid or underpaid for the test months is then projected over the entire audit period. But only "ordinary" transactions or purchases that are representative of the population and are of the type that normally occurred during the entire audit period should be projected over the period. All other "extraordinary" items or transactions should not be projected, but rather should be treated as one-time, nonrecurring transactions in the test period.

The six disputed items that the Assistant Officer changed from ordinary to extraordinary are (1) a cement cooler basin, (2) a transverse carriage assembly, (3) parts for lifters, (4) a power monitoring system, (5) a kiln burner, and (6) pollution control equipment purchased from Pillard. The first five items are machines or machine parts used by the Taxpayer in its cement making process. As indicated, the sixth item is pollution control equipment.

The Taxpayer argues that the disputed purchases were ordinary expenses during the audit period, and thus should be projected, because it purchases machines, machine parts, and pollution control equipment on a regular basis. It claims that the machines, parts, and pollution control equipment purchased during the test months are representative of the machines, parts, and equipment purchased during the entire audit period, and that it is irrelevant that a particular type of machine or equipment may not be purchased regularly.

Rather, a transaction is ordinary, according to the Taxpayer, if the type of transaction, i.e., the purchase of machines, parts, and pollution control equipment, occurs on a regular basis.

The Taxpayer also argues that the Assistant Officer's audit changes are invalid because the statute of limitations had expired before she made the adjustments – "The statute of limitations barred (the Assistant Officer) from removing the transactions from the (projected) sample because the audit period had expired." Taxpayer's Brief at 12. Finally, as discussed, the Taxpayer contends that the pinch valve sleeves are not subject to tax because they become an ingredient or component part of the cement manufactured by the Taxpayer. See generally, Code of Ala. 1975, §40-23-1(9)b.

The Department claims that the items in issue are extraordinary in nature because the specific items were not purchased on a regular basis. In support of its claim, it points out that the disputed items were all purchased in February 2005, and that no similar purchases occurred in the other test month, August 2004. It asserts that "both test months should have similar transactions for these transactions to be considered ordinary." Department's Brief at 3.

Concerning the Taxpayer's statute of limitations argument, the Department contends that if the Taxpayer's claim is correct, "then it would also bar the Department from changing the final result of the audit from a liability to a refund." Department's Brief at 5. Finally, concerning the pinch valve sleeves, the Department argues that the Taxpayer has not proved that the sleeves become a part of the cement. It also argues that the Administrative Law Division cannot address the issue because it was not previously raised by the Taxpayer in its refund petitions and addressed by the Department, citing *HealthSouth*

Corporation v. State of Alabama, Docket BIT. 08-1021 (Admin. Law Div. 7/16/2009, and *QHG of Gadsen, Inc. v. State of Alabama*, Docket S. 10-115 (Admin. Law Div. 7/8/2010). Although not cited by the Department, the case supporting the Department's position on this issue is *Rheem Mfg. Co. v. State, Dept. of Revenue*, 33 So.3d 1 (Ala. Civ. App. 2009), cert. denied (Ala. 2009).

Issue (1). The "Ordinary" Versus "Extraordinary" Transaction Issue.

This is an issue of first impression for the Administrative Law Division, and to my knowledge has never been addressed by the courts in Alabama. The Department also has no regulation that addresses block audits or other statistical sampling audits. The Department did, however, attach to its brief a document from the Multistate Tax Commission ("MTC") that addresses the "Extraordinary Items" issue in statistical sampling audits.[1] The document reads in pertinent part:

> A taxpayer may take exception to an item that has an unusually large adjustment. This type of item may be called an extraordinary item, non-recurring item, exceptional item or an outlier. Since in a simple random sample each item has an equal chance of being selected, it is difficult to make a decision to remove the item from the sample. If the item must be removed because of taxpayer negotiations, the population and the sample base must be reduced by the same dollar amount.
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> Examples would include:
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> 1. A sale of a company asset,
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> 2. Very large dollar invoices, or
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> 3. Unusual or infrequent purchases.

[1] The MTC is an intergovernmental state tax agency that was created by the Multistate Tax Compact in 1967. Alabama is one of twenty full compact members, and twenty eight other states are either sovereignty members or associate and project members. The MTC routinely conducts training sessions and otherwise assists state revenue departments in the administration of the various state tax laws.

As discussed, the Taxpayer claims that the general type of transaction must be considered in determining if a specific purchase during a sample period is ordinary or extraordinary. That is, in deciding if the Taxpayer's purchase of a particular type of machine, part, or equipment during a sample month was ordinary or extraordinary, the deciding factor should be whether the Taxpayer purchased the general type of item on a regular basis, and not whether it purchased the particular item in issue on a regular basis. I agree.

The projectable transactions in a test period should be representative of the types of transactions engaged in by the taxpayer during the audit period. Contrary to the Department's claim, it is not required that the particular item in issue must be purchased in every test period used in a block audit. There is ample evidence that the Taxpayer regularly purchased machines and machine parts used in its manufacturing processes, and also pollution control equipment, during the audit period. Consequently, the disputed machines, parts, and pollution control equipment in issue constituted ordinary purchases by the Taxpayer for purposes of the audit, and thus should be projected over the audit period.[2]

The above holding is also consistent with the MTC guidelines on the issue. To begin, the guidelines state that "[a] taxpayer may take exception to an item that has an unusually large adjustment." It is assumed, however, that in fairness, the Department can

[2] It is not in evidence whether the Department also treated as extraordinary, and thus did not project, various other machines, machine parts, or pollution control equipment concerning which the Taxpayer had underpaid tax during the sample months. If so, those machines, etc. should also be treated as ordinary transactions, and the resulting liabilities should also be projected over the audit period.

also take exception and remove an item that results in an unusually large adjustment. In any case, the transactions in issue are not "unusually large" relative to the Taxpayer's overall purchases.

The disputed transactions also are not of the type set out in the guideline examples. The transactions were not sales of the company's assets, they did not involve very large dollar amounts relative to the Taxpayer's usual purchases, and, as discussed, they were not unusual or infrequent purchases because the Taxpayer regularly purchases machines, machine parts, and pollution control equipment in the course of its operations. There is also no indication that projecting the disputed items would result in distortion, which is another criteria set out in the MTC guidelines.

The transactions in the two test months may not have been generally representative of the transactions over the audit period because in one of the months, February 2005, the Taxpayer had a scheduled outage for maintenance. Most of the disputed purchases in issue occurred in that month. But the Taxpayer is correct that if its February 2005 overpayments skewed the refunds in its favor, then the projected February 2005 underpayments also skewed the liabilities in the Department's favor.

> In this case, including a month with a schedule outage is representative because Holcim has periodic, scheduled outages for repair and maintenance. The Department's argument concerning February 2005 exemplifies its inconsistent application of an alleged standard. Following the Department's reasoning is difficult, but it seems to argue, or at least imply, that Holcim chose these February transactions because projecting the refund based on this month skews the liability in the Department's favor, and the month should not have been in the sample for either purpose. Including February 2005 to project liability, but not to project the refund, is patently unfair. Taxpayer's Hearing Exhibit 2 shows the CDW audit assessment invoices are also dated February 2005. If Holcim's annual outage made the overpayments extraordinary, this same fact should have made the underpayments extraordinary.

Taxpayer's Reply Brief at 2.

I agree that perhaps February 2005 should not have been in the sample for either purpose. But the Department agreed to use the month as a test month, even though it knew or should have known during the audit that the Taxpayer's facility or facilities were at least partially closed for routine maintenance during the month. And again, there is no evidence that using February 2005 as a sample month distorted the audit results.

While I agree with the Taxpayer on this issue, I disagree with how the Taxpayer characterized the Assistant Officer's actions and motives in its Brief and Reply Brief. Some of the comments are demeaning in nature, and state or imply that the Assistant Officer was biased and unfair, if not incompetent, when she reviewed the audit. Samples of the comments follow:

> . . . according to (the Assistant Officer), purchases of machinery and machinery parts that were part of refund claims became extraordinary when projecting the claim for refund, while they remained ordinary when projecting the additional audit assessment. Audit sample transactions became chameleon-like, that is, they took on whatever characteristics were necessary to produce the most revenue for the state without regard for the fairness of the audit. This double standard should not be upheld.

Taxpayer's Brief at 6.

> As seen above, when reviewing Holcim's claim for refund, (the Assistant Officer) determined that some purchases of machinery and machinery parts were extraordinary (non-representative) occurrences and removed them from the projection. On the other hand, when reviewing the audit, (the Assistant Officer) determined that all similar purchases of machinery and machinery parts were ordinary (representative) and remained in the projection when they resulted in additional tax liability.

Taxpayer's Brief at 5.

> While the Department's brief now claims that (the Assistant Officer) was very concerned about the monthly nature of purchases of items in the refund projection, she remained totally unconcerned about the monthly nature of

> purchases in the liability projection.

Taxpayer's Reply Brief at 3.

> The Department's Attachment A also states that removing an item from a sample is a difficult decision. Items in a sample, then, are presumed to be ordinary, and deciding that an item is extraordinary is a special process. The Department's Attachment A leaves the impression that items are designated extraordinary reluctantly. (The Assistant Officer's) decision to designate an item extraordinary was not difficult at all. If the item was in the refund, it was extraordinary, if similar items were in the audit assessment, they were ordinary.

Taxpayer's Reply Brief a 4.

The Assistant Officer has testified before the Administrative Law Division on numerous occasions. My observations have been that she is an efficient, knowledgeable Department employee that tries to be fair and balanced in deciding audit issues. That also applies in this case.

The Assistant Officer was tasked with the job of implementing the changes made by the Assessment Officer, and also reviewing the audit for other final adjustments. She consequently reviewed certain of the items purchased in the test months to determine if they should be projected or treated as extraordinary, nonrecurring items. In doing so, she studied the items on the Internet, and then discussed the items with "upper management," whom I assume to be the Assessment Officer. Only then did she decide if an item was ordinary or extraordinary for projection purposes.

She perhaps should have notified the Taxpayer of her proposed changes and given the Taxpayer's representatives an opportunity to reply. But there is evidence supporting the Assistant Officer's conclusions that the particular machines, parts, and equipment in issue were not regularly purchased by the Taxpayer. Rather, the dispute involves whether

each machine or piece of equipment should be considered separately, as argued by the Department, or whether the regular purchase of machines, etc. as a general category should control, as argued by the Taxpayer. I believe that the Taxpayer's position is the better reasoned view, but given the lack of guidance on the issue, my opinion may be wrong and the Assistant Officer may be right. In any case, the Assistant Officer made her best effort to fairly review the audit, and her conclusions were agreed to by the Assessment Officer, who I also know to be a knowledgeable and fair individual.[3] While the Taxpayer's briefs were otherwise well-written and convincing on this issue, the attacks on the Assistant Officer's integrity and motives were unnecessary. There is truth in the old adage – "You can catch more flies with honey than with vinegar."[4]

Issue (2). The Statute of Limitations Issue.

The Taxpayer argues that the Assistant Officer was barred from altering the block sample because the statute of limitations for assessing tax or petitioning for refunds for the audit period had expired in January 2009. "In 2011, when she removed the refund transactions from the sample, the audit period was no longer open for a detailed examination." Taxpayer's Brief at 11. I disagree.

This is an appeal of partially denied refund petitions. The Taxpayer timely filed the petitions within the extended statute of limitations for doing so. The Department had the duty to review the petitions and decide the amount of the refunds due, if any. The

[3] As indicated, the Assessment Officer agreed with the Taxpayer on most of the issues raised by the Taxpayer after the Assessment Officer issued his informal conference findings on March 17, 2011.

[4] The American Heritage New Dictionary of Cultural Literacy, Third Edition.

Department is technically required to either grant or deny a refund petition within six months, and if the Department fails to act within the six month period, the refund is deemed denied. Code of Ala. 1975, §40-2A-7(c)(3). As a practical matter, however, the Department may on occasion, as in this case, be unable to fully review the petition within the six month period. But even if a refund is technically deemed denied after six months, the Department will usually continue to review the matter for the purpose of determining the refund due, if any.

In short, the Department has no time limit within which it must complete an audit or review of a taxpayer's refund petition. And certainly it is not barred from reviewing and adjusting a taxpayer's liability, and any refund due, after the statute of limitations for filing a petition has expired. As correctly argued by the Department – "If the Taxpayer's argument is correct that the Taxpayer's Bill of Rights barred the Department from determining if a transaction and the error regarding the accrual of taxes is representative of the sample or not, then it would also bar the Department from changing the final result of the audit from a liability to a refund." Department's Brief at 5.

Issue (3). The *Rheem* Issue.

The Department argues that the Administrative Law Division cannot address the Taxpayer's pinch valve sleeve argument because the issue was not previously raised by the Taxpayer and addressed by the Department before the Taxpayer's appeal to the Administrative Law Division. I agree.

Rheem Manf. Co. v. State, Dept. of Revenue, 33 So.3d 1 (Ala. Civ. App. 2005) is controlling on this issue. The Taxpayer concedes that *Rheem* "holds that in appeals involving refunds, the Administrative Law Division cannot address an issue unless it was

previously raised before the Department as a basis for the refund." *HealthSouth Corporation v. State of Alabama*, Docket BIT. 08-1021 (Admin. Law Div. 7/16/2009) at 7. It argues, however, that *Rheem*, and the Administrative Law Division decisions addressing that case, are not on point "because Holcim's purchase of pinch valve sleeves were part of the assessment, not part of the refund claim." Taxpayer's Reply Brief at 10.

The Taxpayer's position is wrong because this appeal involves partially denied refunds, not disputed final assessments. The Department's audit may have determined that the sleeves were taxable, but the audit did not result in a final assessment or assessments that were appealed to the Administrative Law Division. Rather, the final audit results showed refunds due. The Taxpayer appealed to the Administrative Law Division from the deemed denied refunds, but failed to raise the pinch valve sleeve issue before appealing. The issue apparently was not otherwise addressed by the Department before the appeal, and was first raised by the Taxpayer in a notice to the Administrative Law Division in October 2011. Consequently, the Administrative Law Division is barred by *Rheem* from addressing the issue.[5]

[5] I respectfully disagree with the *Rheem* rationale for the reasons explained in *HealthSouth Corporation v. State of Alabama*, Docket BIT. 08-1021 (Admin. Law Div. 7/16/2009) at page 8, n.3; and *QHG of Gadsen, Inc. v. State of Alabama*, Docket S. 10-115 (Admin. Law Div. 7/8/2010). This case also illustrates another practical problem with the *Rheem* case. The Taxpayer was required by the statute of limitations to appeal the denied refunds before the Department had completed its audit and notified the Taxpayer of the final results. The Taxpayer thus could not have known how the Department taxed many of the items in the audit, and consequently, could not have raised those items as an issue before appealing.

Ideally, the Administrative Law Division should be able to address all issues relating to a taxpayer's liability for the tax period in issue, regardless of when the issue is raised. As long as both parties are allowed to address all issues on appeal before the Division, justice would be served, and the Division could fulfill its mandate "to provide for the fair, efficient, and complete resolution of all matters in dispute." Code of Ala. 1975, §40-2A-9(a).

The Department is directed to recompute the Taxpayer's refunds based on the above findings. A Final Order will then be entered for the adjusted refunds due.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered April 9, 2012.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Margaret Johnson McNeill, Esq.
Whitney Compton, CPA
Joe Walls
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Leslie Michaud

Unfortunately, per the *Rheem* rationale, once a taxpayer appeals a denied refund to the Administrative Law Division, no further issues can be raised, even if the Department's audit of the taxpayer's refund petition is still ongoing when the taxpayer appeals, as in this case.