STATE OF ALABAMA DEPARTMENT OF REVENUE,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. S. 89-223
TELEDYNE INDUSTRIES, INC. d/b/a Teledyne Continental Motors Mobile, AL 36617,	§	
Taxpayer.	§	

FINAL ORDER

The Revenue Department assessed use tax against Teledyne Industries, Inc., d/b/a Teledyne Continental Motors (Taxpayer) for the years 1985 through 1987. The Taxpayer appealed to the Administrative Law Division and hearings were conducted on February 25, 1991 in Montgomery and on March 16, 1992 in Mobile. John Crowley and Fred Helmsing appeared for the Taxpayer at both hearings. Assistant counsel Dan Schmaeling represented the Department.

FINDINGS OF FACT

The Taxpayer operates a facility in Mobile, Alabama at which it develops, manufacturers and sells sophisticated aircraft engines and other high-tech hardware.

The Department audited the Taxpayer and assessed additional use tax for the years 1985 through 1987. The. Department reviewed the audit at an informal conference and reduced the assessment from approximately $112,000 down to approximately $59,000.

The primary issue in dispute is whether certain tangible property purchased by the Taxpayer was subject to the Alabama use

tax, and if so, what was the taxable measure. A second issue is whether certain repair labor charges should be taxed.

The Taxpayer purchased. motors, parts and other tangible property from various out-of-state vendors during the period in issue. The materials either became component parts of hardware manufactured for sale by the Taxpayer, or were used by the Taxpayer in research and development work.

The vendors sometimes provided a stock part to the Taxpayer, but usually were required to perform extensive redesign and engineering work to conform the part to specifications. The vendors either billed the Taxpayer separately for the design and engineering work or included those charges in a lump sum invoice along with the hardware.

The Department contends that the entire amount charged by the vendors should be taxed, including all separately invoiced design and engineering charges and without regard as to whether the materials became a component part of hardware manufactured for sale by the Taxpayer.

The Taxpayer responds. that tax is not due on those materials and parts that became an ingredient or component part of hardware manufactured for sale, citing Code of Ala.. 1975, 940-23-60(4)b.

The Taxpayer next argues that if an item is taxable, then the taxable measure ("sales price") should include only the ordinary labor costs associated with the manufacture of the property. The Taxpayer contends that all extraordinary design and engineering

charges should be excluded. from the taxable measure, whether separately invoiced or included in a lump, sum along with the hardware. The Taxpayer presented testimony estimating what portion of the lump sum invoices constituted hardware and what part constituted engineering and design charges.

The vendors also performed engineering, design, testing and repair work on materials already owned by the Taxpayer or otherwise unrelated to the sale of tangible property. The Department concedes that those services not incidental or related to the sale of tangible property by a vendor are not taxable.

However, the repairs sometimes included the sale of new parts to the Taxpayer. The Department argues that the entire repair charge must be taxed if the non-taxable labor and taxable parts are not separated on the invoice. The Taxpayer concedes that point, see transcript of March 16 hearing, at page 46.

CONCLUSIONS OF LAW

"Wholesale Sale" is defined in part at Code of Ala. 1975, §40-23-60(4)b. as "a sale of tangible personal property ..... to a manufacturer or compounder which enter into and become an ingredient or component part of the tangible personal property or products which such manufacturer or compounder manufactures or compounds for sale, . . ." Applying the above definition to this case, all materials that subsequently became a component part of hardware manufactured for sale by the Taxpayer were purchased at

wholesale and therefore are not taxable. See, State v. Kershaw Mfg. Co., Inc.., 372 So.2d 1325 (1979), and State v. Thiokol Chem. Corp., 246 So.2d 447. The Taxpayer must prove that the materials became a component part hardware manufactured for sale. Without adequate proof, the materials must be taxed.

On the other hand, the parts and materials used by the Taxpayer which did not become a component part of property manufactured for sale are taxable. Included in that category are the prototypes used in research and development and not resold by the Taxpayer. The issue then becomes what is the taxable measure, or "sales price", of that taxable property.

The Taxpayer claims that extraordinary design and engineering charges should not be taxed. However, "Sales Price" is defined at Code of Ala. 1975, §40-23-60(10) as "the total amount for which tangible personal property is sold, including any services, . . . without any deduction therefrom on account of the cost of the property sold, the cost of the materials used, labor or service cost, interest charged, losses or any other expenses whatsoever;....."

Under the above definition, all labor costs incurred in developing, manufacturing or modifying a specific piece of hardware for sale are taxable. There is no distinction between "normal" and "extraordinary" labor charges. The fact that the labor charges are of a special, one-time nature is not relevant. Nor is the fact

that in some cases the engineering and design charges are separately invoiced by the vendor. A vendor (or in this case the vendor's customer) cannot avoid tax by separately invoicing the various labor costs involved in developing and manufacturing a specific item for sale.

An analogous situation involves transportation charges. If the seller is required to deliver the sales item as part of the sale, the transportation is necessary to the sale and is taxable, even if separately invoiced. See East Brewton Materials, Inc. v. State, Dept. of Revenue, 233 So.2d 751. Likewise, engineering and design modifications. required by the Taxpayer and necessary to prepare a part for sale are taxable even if separately invoiced.

The second sentence of the Reg. 810-6-1-.84 provides that "services not necessarily or customarily performed incidental to the sale of property or services unusual in nature" are not taxable. I agree that labor not incidental to the sale of tangible property is not taxable. However, all labor costs, no matter how unusual, are taxable if incurred, or incidental to the manufacture of tangible property for sale. Labor costs incurred in redesigning and engineering a unique, special-ordered motor should be included in the taxable measure the same as common labor necessary to mass produce an item.

Repair labor is not taxable because it is not incurred in the manufacture of tangible property for sale. See generally, Sparks. v. Louisville and Nashville R.R. Co., 166 So. 2d 865. However, if

the repair also involves the sale of a part or materials, the taxpayer must keep specific records distinguishing taxable parts and non-taxable labor. The entire repair charge must be taxed if adequate records. separating the two are not maintained. See, State v. Ludlam, 384 So.2d 1089.

In summary, all- labor costs incurred in designing, engineering, and manufacturing tangible property is taxable. Whether the sales item is mass-produced or one of a kind is not relevant. Nor is the fact that the labor constitutes a major portion of the overall cost. Where the Taxpayer ordered a special part requiring redesign and engineering indications, those costs were necessary to prepare the part for sale and are therefore taxable, even if separately invoiced.

On the other hand, design and engineering work unrelated to a specific piece of hardware or performed on a part already owned by the Taxpayer is not taxable. Sometimes the distinction is not clear. For example, the Taxpayer may have hired a vendor to do independent engineering or design work, but along with the written plans or blueprints the vendor also delivered a model or prototype resulting from the work. As a general rule, if the engineering and design work is incidental and necessary to the sale of the hardware, those charges are taxable. If the hardware is incidental to the engineering and design services, then only the separately invoiced hardware is taxable.

Each transaction must be decided on a case-by-case basis.

However, in all cases. adequate, contemporaneously prepared records must be available distinguishing non-taxable services and taxable hardware. Unverified testimony identifying what part of a lump sum invoice consists of non-taxable labor is not sufficient. See, State v. Mack, 411 So.2d 799.

As agreed by the parties, the issues in dispute have been addressed in broad, non-specific terms. The Department is directed to review the audit and adjust the assessment based on this Final Order. The reaudit report should explain why each item or category of items is being taxed. The preliminary assessment should then be made final as adjusted.

Entered on May 4, 1992

_____
BILL THOMPSON
Chief Administrative Law Judge