



STATE OF ARKANSAS
**Department of Finance
and Administration**

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March 14, 2016

[REDACTED]
[REDACTED]
[REDACTED]

Re: Request for Revision
In the Matter of [REDACTED]
Docket No: 16-014

[REDACTED]:

This letter is prepared in response to your request on behalf of your client, [REDACTED] ("Taxpayer") for a revision of the Administrative Decision entered herein on December 16, 2015. Your letter dated January 4, 2016 is considered a timely filed request for revision and this letter will constitute the final decision of the Department of Finance and Administration under the provisions of Ark. Code Ann. § 26-18-405 (Supp. 2015). Following a review of your revision request letter, the administrative hearing decision, and the documentation contained in the case file, the Administrative Decision should be sustained in full.

BACKGROUND

Taxpayer is a retail jewelry and gift store located in [REDACTED], Arkansas, which sells merchandise such as diamonds, pearls, bracelets, watches, accessories, jewelry accessories and other miscellaneous gift items. Taxpayer also provides jewelry repair services to its customers.

A gross receipts and compensating use tax audit of the Taxpayer's business records was conducted by auditor Donnita Jeffery for the April 1, 2009 to February 28, 2015 period. The auditor reviewed all of Taxpayer's out-of-state taxable invoices that did not include tax and for which tax had not been accrued. Taxpayer was a non-filer for consumer use tax, and therefore the audit was extended to cover six (6) years. Taxpayer was assessed for unpaid compensating use tax and interest in the amount of \$ [REDACTED]¹ for the unreported out-of-state taxable purchases of "bags, wrapping and tissue paper, ribbons, repair envelopes, tools and supplies, jewelry pads, risers, and liners" (hereafter referred to collectively as "preparation and packaging material" or "materials").

A hearing was conducted on September 29, 2015, in Little Rock, Arkansas, to determine whether the assessment made by the Department should be sustained. The auditor and her supervisor,

¹ The amount of the proposed assessment will be adjusted to reflect certain items conceded by the Department.

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Yaminah Hawkins, appeared for the Department. [REDACTED] appeared for the Taxpayer. At the hearing, the Taxpayer testified that a [REDACTED] ([REDACTED]%) percent mark-up is applied to and included in the retail price of the sale of its merchandise and repair service. Taxpayer could not, however, point to a separate and distinct component of the retail price of its merchandise or repair service directly allocable to the preparation and packaging material at issue.

At the conclusion of the hearing, the hearing officer requested post-hearing briefs regarding Taxpayer's claim of entitlement to the manufacturing exemption for its purchases of the preparation and packaging material and certain other items of tangible personal property. The record remained open until November 13, 2015 for the submission of post-hearing briefs.

The use tax assessment made by the Department was sustained, in part. The December 16, 2015 Administrative Decision determined that Taxpayer was not entitled to claim the manufacturing exemption pursuant to Ark. Code Ann. § 26-52-401(12)(B)(i) and GR-55 for its purchases of the materials at issue here or for certain other items of tangible personal property used in crafting customized jewelry. Taxpayer's request for revision does not challenge the hearing officer's conclusion that Taxpayer is not a "manufacturer" for Arkansas gross receipts tax purposes. Taxpayer asserts only that the hearing officer incorrectly concluded that the purchase of the materials herein do not qualify for the sale for resale exemption.

As a preliminary matter, the hearing officer correctly cited the standard of proof for a taxpayer to prove entitlement to an exemption, deduction, or credit, which is by a preponderance of the evidence. Ark. Code Ann. § 26-18-313 (Supp. 2015). When a taxpayer claims to be entitled to a tax exemption, deduction, or credit under the terms of the state tax law, the statute providing the tax exemption, deduction, or credit shall be strictly construed in limitation of the exemption, deduction, or credit. *Id.*

TAXPAYER'S REQUEST FOR REVISION

The Taxpayer claims that the hearing officer failed to consider certain facts and evidence provided in support of its argument that the purchases of preparation and packaging material qualifies for exemption under Ark. Code Ann. § 26-52-401(12)(A) as a sale for resale. The Administrative Decision incorporated and referenced all documentary evidence, written briefs submitted by the parties, and testimony presented by the Taxpayer (pages 2-12). The Decision contains the positions taken by both the Taxpayer and the Department. The hearing officer set out in detail the arguments made by each party and considered those arguments in the rendering of his decision. In his letter revision request letter, Taxpayer presented no additional facts for consideration by the Department, but instead repeated in summary form the facts previously presented to the hearing officer. The Taxpayer's contention that the hearing officer failed to consider all of the facts presented by the Taxpayer is inaccurate. The factual findings made by the hearing officer are not in dispute and are hereby adopted for purposes of this response.

SALES FOR RESALE

As previously stated, the Taxpayer has presented no new or additional evidence that it resells preparation and packaging material to its customers. Instead, Taxpayer reiterates that he is in the business of selling “moments and surprises,” and that this cannot be accomplished without selling a complete product that is finished and wrapped (“wrapped gifts”). Specifically, Taxpayer continues his claim that the materials at issue qualify for the exemption as necessary packaging of an assembled or prepared product which becomes a component part of the final packaged article.

Arkansas Code Annotated § 26-52-401(12) (Supp. 2015) provides a narrow sales and use tax exemption for purchasers regularly engaged in the business of reselling the articles purchased. Thus, whether the sale for resale exemption applies turns on whether the Taxpayer is regularly engaged in the business of reselling the items or articles purchased. The hearing officer considered all arguments made by the Taxpayer and pointed out that: (1) Arkansas provides no specific exemption for gift wrapping materials or paper bags; and, that (2) the arguments made by Taxpayer are inconsistent with controlling case law from the Arkansas Supreme Court.

The hearing officer relied upon *Dermott Grocery & Commission Co. v. Hardin*, 203 Ark. 446, 156 S.W.2d 882 (1941), where the court determined that sacks and packaging material used by a merchant to deliver merchandise to a consumer may not be purchased by the merchant tax-free as a sale for resale. In that case, the court determined that the items were consumed by the merchant in the course of its business. The appellant argued, as does the Taxpayer herein, that “paper boxes, paper bags, twine, wrapping paper, and other materials used to deliver merchandise to customers are resold by the retailer and become a component part of the packaged articles and that they merge into and become an element in the cost of the final article sold by the retailer.” The *Hardin* court determined that the sole question presented in that case was whether the wrapping paper, paper sacks, and other materials were exempt as a sale for resale. The court made the following findings of fact:

In no instance of sale was a specific or separate charge made by the merchant for the commodity, or commodities so used in wrapping or packaging the merchandise. The buyer of the merchandise from the retail merchants paid no greater amount for the articles of merchandise, by reason of the commodities used by the merchants in wrapping or packaging the merchandise than would have been paid had the merchandise been delivered to the customer without using such commodities as paper sacks, paper boxes, wrapping paper, etc. *Id* at 883.

[...]

The retail merchants were engaged in selling merchandise and as an incident to their business, for sanitary purposes to entice trade, and as a matter of convenience for the customer, used and consumed in their business the

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commodities mentioned. *Id* at 884. [...] No contention is made here that the commodities named are sold for on price and the merchandise for another. *Id.*

Based on those facts, the court stated, “[W]e think it clear that the commodities named here when sold by appellant to the retail merchants did not become a ‘recognizable, integral part of the manufactured, compounded, processed, assembled or prepared **products’ but that such commodities were sold to retail merchants for their consumption and use, and as an aid, in carrying on their retail business.**” [Emphasis added]. *See also Wiseman v. Arkansas Wholesale Grocers’ Ass’n*, 192 Ark. 313, 90 S.W.2d 987 (1936) (court found that “items such as paper grocery bags that are not separately billed to retail customers by retailers do not qualify for the sale for resale exemption.”). Here, Taxpayer made all the same arguments as the appellant in the *Hardin* case concerning the sale for resale exemption. None of the materials at issue here are resold or separately billed to Taxpayer’s retail customers. Rather, Taxpayer uses and consumes the materials in conduct of his retail jewelry business to entice trade and as a matter of convenience for his customers.

In *Hervey v. Southern Wooden Box*, 253 Ark. 290, 486 S.W.2d 65 (1972), the court analyzed the ruling in *Arkansas Wholesale Grocers* and explained that the cost of paper bags were not directly allocable to the particular product being sold, such as a drink contained in a single cup, and therefore were not considered in the pricing of the goods sold. Rather, the retailer considered the goods a business expense and thus part of its overhead along with rent and utility costs. Under those facts, the court expressed agreement with its earlier holding that the bags were not resold to retail customers but sold to retailers who use and consume the bags in conduct of their business. Here, although Taxpayer argues that its [REDACTED] (%) percent mark-up method proves that the cost of the materials are considered in the pricing of the merchandise, Taxpayer cannot point to a separate and distinct component of the retail price of the merchandise that is directly allocable to the materials. Taxpayer’s explanation and Exhibits regarding its [REDACTED] % mark-up method, even if taken as true, fails to demonstrate or provide proof that a separate and distinct component of the retail price of the merchandise is directly allocable to the preparation and packaging materials.

The Taxpayer incorrectly relies on a line of cases standing in contrast to the *Hardin* case. To support its argument that the cost of gifts sold include the cost of the materials that become a part of the merchandise, Taxpayer points to *Heath v. Little Rock Paper Co.*, 257 Ark. 715, 520 S.W.2d 196 (1975) and states, “It is well settled that the clear legislative intent... was to exempt purchases that are made for the purpose of resale, to the end that the same property will not be twice subjected to the same tax.” Here, Taxpayer claims that because the cost of the materials is built-in to the final retail price of the merchandise, the assessment amounts to double taxation by DFA. In further reliance on *Little Rock Paper Co.*, Taxpayer states, “The court found that supplies such as styrofoam cups used to dispense soft drinks, the lids for such cups, paper bowls and wrappers used in the dispensing of pies and pastries, etc. were exempt from tax as the price charged for the food items included the price of the paper product it was served in.”

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Although the facts in *Little Rock Paper Co.* may sound on point to the Taxpayer, the pertinent facts and legal construction of the issue in that case is misplaced and incorrect when applied to the Taxpayer's argument herein. In *Little Rock Paper Co.*, the Arkansas Supreme Court determined that "necessary packaging of an assembled or prepared product, such as food wrappers, cups, or containers, can be considered component parts of the finished product and therefore qualify for the sale for resale exemption even though the cost of such items is not separately billed to customers." The court considered fast food packaging such as cups, wrappers, and containers for chicken pieces for particular meals. Further, the testimony in that case demonstrated that the packaging was directly allocable to certain products and was considered in the pricing of those products and thus qualified as exempt. In considering items of general use, however, such as straws, stirrers, utensils, napkins, and even *paper sacks*, the court concluded that such items were *clearly taxable* under its holding in *Arkansas Wholesale Grocers*.

Taxpayer also points to *McCarroll v. Scott Paper Box Co.*, 195 Ark. 1105, 115 S.W.2d 839 (1938) and states, "A paper box used to sell biscuits is exempt when the price of the box was measured into and became an element in the cost to the final consumer." Again, although the facts in *Scott Paper Box Co.* may sound on point to the Taxpayer, the pertinent facts and legal construction of the issue in that case is misapplied and incorrect when applied to the argument herein. In *Scott Paper Box Co.*, the court analyzed boxes that were sold to a manufacturer and subsequently used in packaging of baked products for retail sale. The costs of the boxes were considered in the retail pricing of the products and directly allocable to certain products.² The court concluded that the boxes were exempt because they "became components of the product ultimately sold in packaged form to retail customers." To distinguish *Arkansas Wholesale Grocers*, the court noted that the boxes at issue in *Scott Paper Box Co.* were component parts of the products sold at retail and the cost of the boxes were used in calculating the purchase price of the items sold to its retail customers.

Here, unlike the grocery items at issue in *Arkansas Wholesale Grocers*, jewelry is expensive and may be susceptible to loss or damage without protective packaging. As a result, the price of a piece of jewelry is not determined "without reference to the attributes of delivery." The Department has already acknowledged that jewelry boxes are entitled to exemption as a sale for resale because they are analogous to: (1) the boxes and foil wrappers used as containers for sandwiches in *Little Rock Paper Co.*; (2) the paper boxes used in the sale of biscuits, prepackaged cakes, cookies, and other items in *Scott Paper Box Co.*; and (3) the paper cups sold for vending machine use in *Arkansas Wholesale Grocers*. For this reason, no jewelry boxes were assessed during the audit.³

² Although Taxpayer listed "jewelry boxes" in its list of protested items, it should be noted that the audit contained no adjustments with regard to "jewelry box" purchases.

³ Taxpayer claims that at the hearing the Department agreed to remove some jewelry boxes that had been included in the audit by mistake. As stated previously, the audit contained no adjustments with regard to "jewelry box" purchases. The item described as "jewelry box cotton" was picked up by the audit because the auditor believed the purchase to be for cotton (used in a jewelry box). At the hearing, Taxpayer

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With regard to the cases relied on by Taxpayer, it should be noted that Taxpayer is not a restaurant or a manufacturer. Further, the preparation and packaging materials herein are not directly allocable to the Taxpayers' sales of jewelry and jewelry repair service, nor is the cost of such material separately billed to its customers. Although the materials may appear to Taxpayer to be analogous to the necessary packaging of a prepared product that becomes a recognizable part of the merchandise such as cups, wrapper and containers for chicken pieces or assembled products such as packaged baked items for retail sale, the materials herein do not become component parts of the finished product such that they qualify for the sale for resale exemption. In fact, the materials herein actually appear to be more analogous to the items found in *Little Rock Paper Co.* as general use items such as straws, stirrers, utensil, napkins, and paper sacks, and are therefore taxable under *Arkansas Wholesale Grocers*. Even assuming similarity of such items, it is apparent that such materials would not qualify for the exemption pursuant to this line of cases. Therefore, the arguments put forth by Taxpayer are misapplied and inconsistent with current Arkansas law.

In accordance with controlling precedent, the hearing officer correctly concluded that the preparation and packaging material herein are equivalent to the wrapping paper, paper bags, and other delivery materials used in the *Hardin* case and therefore do not become a recognizable, integral part of the final product for retail sale. The Taxpayer is engaged in the business of selling jewelry and gifts at retail, and therefore purchases such materials for its consumption and use, and as an aid in carrying on that business. The facts here allow for no other conclusion.

CONCLUSION

The Administrative Decision clearly reflects that the hearing officer considered all of the evidence presented by the Taxpayer. The hearing officer considered the facts and evidence when applying controlling Arkansas case law and correctly determined that Taxpayer failed to prove entitlement to the sale-for-resale exemption under Ark. Code Ann. § 26-52-401(12) (Supp. 2015).

The administrative decision is sustained. This concludes Taxpayer's administrative remedies under the Tax Procedure Act. Relief from this decision may be sought according to the procedure set forth in Ark. Code Ann. § 26-18-406 (Supp. 2015).

Sincerely,

Tim Leathers
Deputy Director and
Commissioner of Revenue

explained that the item was actually a small box with cotton in it. The Department agreed to remove the items described as "jewelry box cotton."